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Managing Editor

The NEW YORK CERTIFIED PUBLIC ACCOUNTANT *is published monthly. Copies may be obtained at the office of the Society at twenty-five cents per copy, $3.00 per year.*

[The matter contained in this publication, unless otherwise stated, will not be binding upon the Society; and it should be understood that any opinions expressed in articles published herein are the opinions of the authors of the articles, respectively, and are not promulgated by the Society.]

Jan

Message from the President

To the Members

We face the new year with one main objective—to render all possible service to our country. Our profession has responded promptly to all calls made upon it since the beginning of the present emergency and it stands ready to continue to serve wholeheartedly. Many opportunities for necessary service will arise in the near future, and I ask all members of our Society to cooperate to the utmost of their ability.

When victory shall have been achieved, it will then be said of us that we also served our country faithfully and well.

ANDREW STEWART,
President.

STATE SOCIETY ACTIVITIES

Calendar of Events

January 8—Regular Meeting of the Board of Directors.

January 12—7:30 P.M.—Society Meeting. Subject: **The Business Outlook, Inflation, and Problems Confronting Public Accountants.** Location: Waldorf-Astoria Hotel, Lexington Avenue and 49th Street, New York City.

January 19—8 P.M.—Special Tax Meeting. Subject: **Tax Problems Involving Depreciation, Depletion, and Amortization.** Location: Engineering Auditorium, 29 W. 39th Street, New York City.

February 9—8 P.M.—Special Tax Meeting. Subject: **Problems on 1941 Excess Profit Tax Returns.** Location: Engineering Auditorium, 29 W. 39th Street, New York City.

February 19—Regular Meeting of the Board of Directors.

Federal Tax Meetings

The first in the series of monthly meetings on federal taxation was held on December 15, 1941, in the auditorium of the Engineering Society Building. Discussion was based on the subject of "Inventory and Other Year-End Tax Problems," and was led by Nathaniel B. Bergman, assisted by Messrs. Byerly and Meyer, members of the Federal Taxation Committee. Mr. Bergman prefaced the discussion by the presentation of a short paper.

The second of these federal tax meetings will be held at 8:00 p.m. on Monday evening, January 19, 1942, at the Engineering Auditorium. The subject will be "Tax Problems Involving Depreciation, Depletion, and Amortization," and the meeting will be conducted by Francis P. Byerly, who will be assisted by Messrs. Peter Guy Evans and Vincent H. Maloney. On the evening of February 9, 1942, the third monthly meeting will be held, and the subject will be "Problems on 1941 Excess Profit Tax Returns." The meeting will be in charge of Leslie Mills, vice-chairman of the Committee, who will be assisted by Messrs. Campbell and Ross.

Following the meeting on February 9th, the next tax session will take place on the evening of March 2, 1942, the subject to be subsequently announced (see below).

March Society Meeting

As previously announced, the date of the regular Society meeting scheduled for March 23, 1942, has been changed to Monday, March 2, 1942, and will comprise the fourth in the series of tax meetings sponsored by the Society's Committee on Federal Taxation.

The March 2nd meeting will, therefore, constitute the regular March meeting of the Society at which business may be conducted; it will not be held at the Waldorf-Astoria Hotel, but will take place in the main auditorium of the Engineering Society Building, 29 West 39th Street, New York City, commencing at 7:30 p.m. It is planned to devote this particular meeting to last-minute discussions of tax problems arising before the March 15th deadline.

No February Meeting

As provided in the By-laws of the Society, the Board of Directors has again dispensed with the February Society meeting because of the fact that members will be under

extra heavy pressure during that month.

The next regular meeting of the Society (see above) is scheduled for March 2, 1942.

January Society Meeting

On the evening of January 12, 1942, the Society had the pleasure of hearing an address by Dr. Marcus Nadler, Professor of Finance of New York University, on the subject of "War and the Possibility of Inflation." This was followed by the presentation of a paper by Charles H. Towns, C.P.A., member of the Society, on "Some Wartime Problems of Public Accountants."

In opening the meeting Mr. Andrew Stewart, president, addressed the following remarks to the membership:

"The fact that we meet here tonight on schedule means that your Board of Directors, after serious consideration, has decided that, notwithstanding the fact that we are at war, we should carry on with confidence that we, too, have a serious duty to maintain as far as we can, the important service we render to society and, in so doing, to make our contribution to ultimate victory.

"Those of us who do not join the armed forces will be beset with many problems and faced with long hours of arduous labor. For the most part, we shall have to get along with reduced staffs and the profession as a whole will have to make many sacrifices.

"Your Board of Directors, having considered the present problems at great length, feels that, because of the new problems which will be encountered, we should carry out our program as originally scheduled giving due regard to changes in topics from time to time as occasion may demand. Our schedule of monthly tax meetings is considered essential to the successful accomplishment of our national and state tax programs. Technical meetings are more necessary now than ever and obviously the topics to be covered will deal principally with those special problems which have arisen because of the war. Likewise our monthly meetings will be continued and it is hoped that all of this effort will be not merely an aid to all members in the exercise of their professional functions but also an inspiration to them to aid the national interest in many other ways.

"Because of the importance of the present situation, instead of having the usual formal report from the Board of Directors read, I wish to make that report myself.

"I have already told you of the decisions of the Board with regard to our program of meetings.

"Next in importance comes the work of the Public Relations Committee in drafting a plan under which members and their employees could subscribe to Defense Bonds and Stamps through monthly contributions by payroll deductions or otherwise. After our plan was prepared one of our members, Mr. Rodney F. Starkey, was requested by the Treasury Department to act as Chairman of the Accountants' Group of the Professional Division of this drive. The Society will now cooperate with Mr. Starkey to the end that all members and their employees will have an opportunity of making current subscriptions to Defense Bonds.

"Since the last regular meeting of the Society on December 8, the Board of Directors has held one regular meeting on January 8, 1942, at which eleven applicants were elected to membership, and five associate members were advanced to full membership. The deaths of two members were reported. The Board accepted the resignations of five members and three associate members. There are at present on the rolls, 3,509 members, 2 life members, and 435 associate members, making a total of 3 946.

"The Board has recently authorized a prize essay contest open to members and associate members who are employed on the staff of a practicing accountant or firm of accountants, for which there will be prizes of $200.00 for first prize and $100.00 for second prize. The Publications Committee has prepared rules for this contest, which will be published in the near future.

"The Board has approved of an appropriation of $750.00 for the purpose of awarding student prizes of $25.00 each for high scholarship in accounting in registered colleges and universities of the State of New York.

"Our Committee on Federal Taxation is actively engaged in preparing recommendations in connection with the proposed new tax bill, which will probably be submitted in the first instance to the Treasury Department."

Committee Activities Department

On page 292 of this issue will be found a new department entitled *Committee Activities*, which has been set up for the purpose of publishing material and proceedings emanating

from the large number of special technical committee meetings now being held by the Society.

This department will include short papers presented at such meetings, questions and answers, and digest of any interesting discussions taking place which, in the opinion of the respective committees, should be of interest and value to the membership at large.

Any questions on the part of the readers with respect to subjects discussed in this department may be referred to the chairman of the particular committee involved, in care of the office of the Society.

"Please Check Your Account"

On December 6, 1941, a copy of the leaflet "Please Check Your Account," was sent to each member of the Society with a communication from Mr. J. Arthur Marvin, Chairman of the Committee on Public Relations. This letter is reproduced below, together with the text of the leaflet itself.

December 6, 1941.

To the Members:

Confirmation of accounts receivable is a problem of much concern to accountants today. There exists considerable confusion on the part of clients' customers with respect to this phase of audit procedure, which is caused by the fact that in many cases customers are not aware of the true purpose of these confirmations.

To help inform the public of the necessity for confirmations on the part of the auditor—which in turn should tend to simplify the work of the auditor himself—the enclosed leaflet entitled **Please Check Your Account** has been prepared by the American Institute of Accountants, and is being sent to you by the Society's Committee on Public Relations. The Committee suggests that wherever possible a copy of this leaflet be enclosed with each confirmation request mailed to your clients' customers. (The permission of the client should be secured beforehand in all cases.)

The Society is cooperating with the Institute in an endeavor to effect the greatest possible distribution of this leaflet among business men and the public, and asks the assistance of its membership in carrying out this objective. In addition to clarifying the procedure with respect to confirmation of accounts receivable, it also presents an excellent opportunity for the profession to inform the general public of the importance of independent audits by certified public accountants.

Copies of **Please Check Your Account** are available at the office of the Society at a cost of 35 cents per hundred. An order form is included for your convenience.

Very truly yours,

J. ARTHUR MARVIN, *Chairman,*
Committee on Public Relations.

Please Check Your Account

From time to time you receive, from concerns from which you buy, statements of your account, with a request—

1. That you advise the certified public accountant, acting as independent auditor, whether or not the balance shown is correct, or

2. That you advise the auditor only if you believe the balance is incorrect.

These requests are not an indirect way of urging you to make payment. The certified public accountant is neither a bill collector nor a credit man.

He is an independent auditor, who is checking the books of the concern with which you do business to find out whether the accounts are stated as they should be.

The best way he can learn whether or not the books correctly state your outstanding account is by *checking with you*.

By coöperating with the auditor in meeting the request—

You protect yourself against a misstatement of your account in the company's records which might later cause you annoyance or embarrassment.

You protect the stockholders by affording means of informing them as to the condition of the books and records of the company.

You protect employees of the company by furnishing evidence that they have kept the accounts accurately.

Your Cooperation Is a Public Service

Accounts receivable are often a large part of a company's assets. Banks which lend the company money, stockholders who own the company, investors who may buy its securities, want the opinion of an independent certified public accountant on the company's financial statements, which include accounts receivable.

The certified public accountant's job is to get at the facts, and in this he needs your help. By coöperating, you will help the company maintain a sound credit standing and aid the orderly conduct of business.

Your coöperation will also be appreciated by the national organization of certified public accountants, the American Institute of Accountants, which publishes this leaflet in the interest of sound auditing procedure—for the benefit of all concerned.

With few exceptions, "confirmation of notes and accounts receivable by direct communication with debtors shall be regarded as generally accepted auditing procedure in the examination of the accounts of a concern whose financial statements are accompanied by an independent certified public accountant's report." —("Extensions of Auditing Procedure," American Institute of Accountants, 1939).

Erratum

In the Society's 1941 Year Book issued last month, Mr. Solomon Klausner, 7 Dey Street, New York City, was incorrectly listed as a partner of **Klausner and Todt,** 744 Broad Street, Newark, N. J.

Mr. Klausner has never been affiliated with this firm, and the Publications Committee takes this opportunity of calling a regrettable error to the attention of the members.

William M. Ross

Word has just been received of the death on December 24, 1941, of William M. Ross, a member of the Society since December 1916.

The Society has suffered a real loss in the passing of this valued and esteemed member.

HAVE YOU MADE YOUR CONTRIBUTION TO

THE AMERICAN RED CROSS

WAR FUND?

PROFESSIONAL COMMENT

Wages and Hours

Overtime Payments to Accounting Employees

Of interest to accountants will be a recent opinion of the Wage and Hour Division for the New York area with respect to the establishment of two different methods for computing overtime payments to employees, which tends to ease the burden on accounting firms during the tax season.

The Society received a letter from one of its members in which the question was raised as to whether or not it was permissible for an accounting firm to establish two regular work weeks during the year, one during the normal season and the other for computing overtime during the ten-week busy season preceding March 15th. The text of this letter, which was forwarded to the Wage and Hour Division, and that of the reply received is published herewith.

October 31, 1941.

The New York State Society of
Certified Public Accountants
15 East 41st Street
New York, New York

Re: **Wages and Hours**

Gentlemen:

On October 21 last, the writer attended a meeting of the Albany Chapter of the Society, at which meeting * * * I brought up some questions relative to the Wage & Hour Law as it affects the Accountant as employer, and I desire to pass on the main point of the discussion, in order to determine if the Society is familiar with same, and if the plan has been put into practice by any members of the Society.

Last year, when it was ruled that Accountants were subject to the Wage & Hour Law, our office lived up to the regulations in the following manner:

Assume that our employee was engaged to work a regular work week of 40 hours for $40.00 a week, or at the rate of $1.00 per hour. If this employee worked 50 hours, we paid him $40.00 for the regular 40 hours and for the 10 hours overtime, at the rate of $1.50 per hour or $15.00 extra, for a total week's pay of $55.00.

If he worked, say, 60 hours we paid him $40.00 regular, plus 20 hours overtime at $1.50 or $30.00 extra, for a total pay of $70.00. We have a small organization of eight employees; nevertheless, this placed a tremendous burden on us during tax season and one which we could not entirely pass on to our clients, and we sought a solution.

Now comes the solution, according to the discussions that I carried on with the representatives of the Wage & Hour Division at the aforesaid meeting.

As I understand it, we are permitted to establish two regular work weeks, one, let us say, of 40 hours for 42 weeks of the year and one of say 60 hours for the remaining 10 weeks of the year (during the 10 weeks income tax rush). Under this plan of two established work weeks, the pay of the same individual cited would be as follows:

We will assume that during the 42 weeks he only works the 40 hours per week according to the estab-

lished work week for that period. During tax season, however, when the established work week is 60 hours, his pay for the 60 hours would be as follows:

For the 60 hours at regular pay	$40.00
For the 20 hours overtime @ $.333	6.66
Total pay for the week	$46.66

This overtime pay is determined as follows: his regular rate of pay for these established work weeks becomes $.666 per hour which is $40.00 regular pay divided by the 60 hours established work week, and for the 20 overtime hours he is to receive an additional half time or $.333 per hour or a total of $6.66.

Under our last year's arrangement he received $1.00 per hour regular rate of pay and $1.50 per hour for overtime which means that for a 60 hour week he received a total pay of $70.00 as against this new pay of $46.66, a saving on this employee for the week of $23.34.

I understand that if such employee works 70 hours in one week, his pay under this new plan would be $40.00 plus (30 times $.333) $9.99, or a total of $49.99 instead of $85.00 under the old plan.

I am very much interested in your reaction to the solution of our problem as outlined in this letter. It is my intention to write to the Legal Department of the Wage & Hour Division in order to obtain a written legal ruling on this question.

One more point that the writer brought up at the aforesaid meeting was the question of whether it would be permissible for me as employer to raise a $40.00 per week man to $50.00 per week during tax season in order to place him in the salary exemption class and then to reduce his pay to $40.00 per week when tax season ended.

U. S. Department of Labor
Wage and Hour Division
341 Ninth Avenue
New York, New York

December 1, 1941.

Gentlemen:

This is in reply to your letters of October 31st and November 27th in which you ask for information concerning the computation of the rate of pay under the Fair Labor Standards Act. You state you have been informed that it is possible to establish two regular workweeks since during certain seasons of the year, particularly during the ten weeks income tax rush, the regular hours of your employees increase from 40 to 60 or over per week. * * *

We have noted the contents of your letters and desire to point out to you that we are aware that it is possible in certain professions such as yours for several different phases to occur during the calendar year. Thus, in one such phase a regular number of hours (such as 40 per week) may be worked while in another phase during the year the irregular or fluctuating workweek formula may occur. Similarly there may be two phases during each of which a different regular number of hours may be worked weekly, the hours being the same regularly within all weeks within each phase, but different as between one phase and the next. Computation of the rate of pay would depend upon the facts in each case.

As to your further question regarding the possibility of raising the salaries of your accountants to $50.00 for certain weeks in order that they may qualify as exempt employees and thus not be subject to the overtime provisions of the Act during the busy season, we wish to advise you that one of the requirements of both Sections 541.2 and 541.3 of the Regulations concerning the Section

13(a)(1) exemption, is that an employee must be compensated for his services on a salary or fee basis at a rate of not less than $200.00 per month. In our opinion the salary requirement is not met by an employee whose salary is brought up to $200.00 in certain months through an arrangement such as you propose.

Commentaries from Various Sources

"Is it necessary only that the modern accountant should be able to *do* things with figures? Is he really the 'practical man' in the last analysis?

"Accounting today is something wider and greater than merely juggling with figures, throwing them into a rigid and determined framework. Accounting is not only a quasi-statistical procedure, it is a branch of sociology.

"In my opinion it is not only technical instruction of which students stand in need so much today, as informed humanism, which should open wide for them the gates of the world, in order to teach them to approach the problems present in industrial and commercial life.

"In the last analysis, is not accounting concerned with sentient human beings?"

Taken from an article by R. E. Maskell entitled "Towards a 'Greater' Accounting," published in the May 1941 issue of THE AUSTRALIAN ACCOUNTANT.

"There is no doubt whatever that Cost Accountancy has a tremendous future, in fact, in time there will be no manufacturing business operated without its aid. The War will call for unity and closer co-operation between practical and theoretical minds in industry, and Cost Accountancy will supply this need."

From a talk by G. H. Gregory before the New South Wales Division of the Australasian Institute of Cost Accountants, July, 1941.

"It seems to me that one of the reasons why accountancy has not more nearly fulfilled its possibilities is the tendency to rely on precedent rather than on the scientific method. My observation of statements leads me to the conclusion that so-called standards in the field of accounting have been too frequently determined by what actually prevails in practice. Once a method has been followed there is a tendency to accept it without question or hesitancy. It becomes the proper thing to do because it has been done before or someone else is doing it. Too often it is accepted without inquiry as to the possible consequences. As a result it gradually develops into an accepted practice."

From an address by Andrew J. Cavanaugh, Assistant Director, Securities & Exchange Commission, before the Middle Atlantic States Accounting Conference June 7, 1941.

Auditors' Remuneration

"The Institute of Chartered Accountants has obtained counsels opinion on the question whether the fee of the auditors of a company must be fixed by the general meeting or whether the function can be delegated to the Board of Directors. The opinion is to the effect that the function cannot be so delegated and a general meeting of the company, which need not necessarily be that at which the auditors are appointed, must fix the fee. It is suggested by the Institute that, in view of this opinion, the following methods are open: (*a*) the resolution appointing the auditors may specify their remuneration for the year of office, (*b*) the resolution may provide that the remuneration will be fixed at a subsequent general meeting, (*c*) the resolution may be silent on the point, leaving the remuneration automatically to fall to be fixed at a subsequent general meeting or (*d*) the resolution may specify a remuneration adequate for the work involved if no exceptional features develop in the audit, a proviso being added to the effect that additional

remuneration will be voted at a subsequent general meeting if the work or other circumstances justify the addition. In the last three cases, counsel consider that in the event of the subsequent general meeting fixing no remuneration (no additional remuneration in the last case) or fixing an illusory or grossly inadequate figure, the auditors could recover reasonable remuneration to be assessed by the Court. In view of this opinion, auditors will wish to take steps to ensure that their fees are duly approved by a general meeting and since additional work may easily arise in present circumstances without being foreseen they will frequently consider course (*a*) inappropriate and may judge course (*d*) to offer the best compromise solution."

From the editorial page of the June, 1941 issue of ACCOUNTANCY, *journal of the Society of Incorporated Accountants and Auditors, London, England.*

Securities and Exchange Commission

Accounting Series Release No. 27 December 11, 1941

The Securities and Exchange Commission today made public an opinion of its Chief Accountant in its Accounting Series discussing the nature of the examination and certificate required by paragraph (4) of Rule N-17F-1 and by paragraph (7) of Rule N-17F-2 under the Investment Company Act of 1940. These rules require that where registered management investment companies retain custody of their portfolio investments, or place them in the custody of a member of a national securities exchange, such investments shall be verified at least three times each year by an independent public accountant.

The opinion, prepared by William W. Werntz, Chief Accountant, follows:

"Inquiry has been made as to the nature of the examination and certificate required by paragraph (4) of Rule N-17F-1 and paragraph (7) of Rule N-17F-2 promulgated under the Investment Company Act of 1940.

"Rule N-17F-2 sets up certain standards to be followed by management investment companies registered under the Investment Company Act of 1940 which maintain in their own custody their portfolio securities and similar investments. Paragraph (7) of that rule is as follows:

> " 'Such securities and investments shall be verified by complete examination by an independent public accountant retained by such registered company at least three times during the fiscal year, at least two of which shall be chosen by such accountant without prior notice to such company. A certificate of such accountant, stating that he has made an examination of such securities and investments and describing the nature and extent of the examination, shall be transmitted to the Commission promptly after each such examination.'

"The securities and investments referred to in the quoted paragraph are identified by paragraphs (1) and (2) of the rule as (a) securities on deposit in a vault or other depository maintained by a bank or other company whose function and physical facilities are supervised by federal or state authority; (b) securities which are collateralized to the extent of their full market value; (c) securities hypothecated, pledged, or placed in escrow for the account of such registered company; and (d) securities in transit. The examination and certificate required by the quoted paragraph should therefore cover all of the securities listed in paragraphs (1) and (2).

"In order to make a complete examination of the securities, it is, in my opinion, necessary for the accountant not only to make a physical examination of the securities themselves, or in certain cases to obtain confirmation, but also to reconcile the physical count or confirmation with the book records. Furthermore, in my opinion it is a necessary prerequisite to such a reconciliation that there have been made an appropriate examination of the investment accounts and supporting records, including an adequate check or analysis of the security transactions since the last examination and the entries pertaining thereto. While the certificate filed must describe the nature and extent of the examination made, it is not necessary that each step taken be set out; instead, there should be included in the certificate in general terms an appropriate description of the scope of the examination of the accounts and the physical examination or confirmation of the securities.

"Finally, in order to meet the requirements of paragraph (7) of Rule N-17F-2 the certificate should comply with the usual technical requirements as to dating, salutation and manual signature and, in addition to the description of the examination made, should set forth:

"(a) the date of the physical count and verification, and the period for which the investment accounts and transactions were examined;

"(b) a clear designation of the depository;

"(c) whether the examination was made without prior notice to the company; and

"(d) the results of the examination.

"Rule N-17F-1 specifies the conditions under which a registered management investment company may place or maintain its securities and investments in the custody of a company which is a member of a national securities exchange. Paragraph (4) of that rule calls for periodic examinations of the securities and investments so placed or maintained and for certificates as to the verification thereof. In my opinion the requirements of such paragraph (4) involve substantially the same considerations as those of paragraph (7) of Rule N-17F-2 and the above discussion is therefore likewise applicable to the examination and certificate required by such paragraph (4)."

It is the Patriotic Duty
of Every American Citizen to:

GIVE to the Red Cross

INVEST in Defense Savings Bonds

Recent Developments in Local Taxation

By LEONARD PRICE, C.P.A.

THOSE of you who attended the forum meeting conducted by the Committee on Municipal and Local Taxation last year, or who read in the March, 1941, issue of the Society's Bulletin the papers delivered at that meeting, will recall the very comprehensive, concise and lucid exposition of the recent developments in local taxation which was presented by Dr. Tunick. I shall endeavor this evening to pick up where Dr. Tunick left off and to present to you a summary of the changes which have occurred in New York City taxation since our meeting a year ago.

Extension of New York City Taxes for Another Year:

You are all well aware of the fact that the various New York City "emergency" taxes which expired on June 30, 1941, were all extended for another year.[1] Such one-year extensions were pursuant to amendment of the New York State General Enabling Act,[2] except in the case of the general business tax, with respect to which the State legislature passed a special enabling act[3] prescribing in detail the type of tax law which the City might enact and permitting the City to tax gross receipts and income until July 1, 1944. The City taxing authorities did not take advantage of this extended period and enacted the current general business tax local law[4] for only one year, namely, to July 1, 1942. It would be merely wishful thinking, however, to infer from this apparent self restraint that we will not have a general business tax for many years to come. In accordance with the restrictions contained in this new enabling act the general business tax rates were reduced to one-half of what they had been. The tax on organizations engaged in general business for profit in New York City during the year ending June 30, 1942, having gross receipts in excess of $10,000.00, was reduced to 1/20th of 1% of gross receipts attributable to New York City. The tax on financial businesses was reduced to 1/10th of 1% of gross income attributable to the City, irrespective of the amount of such gross income.

I should like to direct your attention, in passing, to the fact that the exemption from tax with respect to businesses having gross receipts of $10,000.00 or less, applies to the actual receipts, and that where the measuring period is less than one year, it is *not* necessary to place the receipts on an annual basis in order to determine whether the company need file a return. That is to say, if a company is organized on May 1, 1942, and has gross receipts of $9,500.00 during May and June of that year (those two months would constitute the measuring period), such company will not be required to file a return or pay a tax. Prior to a ruling issued early in February of this year, the City had held that although it was no longer necessary to place receipts on an annual basis for the purpose of determining the tax, it was necessary to do so for purposes of determining whether a return had to be filed.

[1] L. L. 1941, Nos. 48, 49, 50 and 51. [2] L. 1941, C. 200. [3] L. 1941, C. 199.
[4] L. L. 1941, No. 47.

Presented at a meeting of the Committee on Municipal and Local Taxation, December 4, 1941, Stanley B. Tunick, Chairman.

Reduction of Sales Tax Rates:

Of more recent origin are the changes in the sales and compensating use tax laws[5] reducing the sales tax rates from 2% or 3% to a uniform 1% effective last October 27th. In order to eliminate taxes of fractions of a cent, the Comptroller has prescribed the following schedule applicable to receipts from taxable sales:

Selling Price	Tax
1¢ to 24¢	No tax
25¢ to $1.39	1¢
$1.40 to 2.39	2¢
2.40 to 3.39	3¢

and so on adding 1¢ for each dollar or fraction thereof. Receipts from the sale of meals in restaurants, cafes, etc. (including cover or minimum charges or charges for drinks sold with meals) are subject to the following taxes:

Amount	Tax
Less than $1.00	No tax
$1.00 to $1.49	1¢
$1.50 to 2.49	2¢

and so on. Wines, liquors and other alcoholic beverages and drinks compounded thereof or therewith, but not including beer, which are consumed not in connection with the sale of food or if sold with food where the combined charge for food and drink is less than $1.00 are taxed in accordance with the regular sales tax schedule.

You will all recognize that although the tax is nominally one per cent, the foregoing schedule actually increases the effective rate to as high as four per cent. An article selling for 25¢ is taxed 1¢, as is an article selling for 50¢, an article selling for $1.00 or an article selling for $1.39. In the one case the rate of tax is 4%; in the second, 2%; in the third, only 1%; and, in the fourth actually less than one per cent.

The promulgation of the foregoing schedule has not modified the requirement that every vendor must pay to the Treasurer at least one per cent of the total amount of taxable sales including those of 24 cents or less, even though he may not have collected that much tax from his customers. This produces an obvious hardship in the case of those merchants who have many sales at prices less than 25 cents.

Although the recent tax reduction has reduced the sales tax on utility services to one per cent, I mention for purposes of completeness the fact that effective July 14, 1941, the rate was reduced from 3% to 2% and continued at the latter rate until October 26th when, as I indicated above, it was reduced to one per cent.

The reduction of the sales tax rate to one per cent became effective in all instances where delivery of the merchandise was made on or after October 27, 1941, irrespective of when the contract of sale was made. On deliveries made prior thereto, either the two per cent or three per cent rate was applicable. In the case of the sales tax on utility services, the reduction from two per cent to one per cent became effective with respect to all meter readings made on and after November 12th, and in the case of the tax on telephone services, the one per cent rate became effective with respect to all telephone register readings made on and after November 6th. These latter dates appear to have been arrived at for purposes of convenience.

Occupancy Tax on Vending Machines:

One other change of rates has occurred during the past year. By amendment to the law[6] passed on October 18, 1940, and by its terms effective with respect to returns due July 15, 1940, and thereafter, the occupancy tax on vending machines

[5] L. L. 1941, Nos. 88 and 89. [6] L. L. 1940, No. 125.

is determined on the basis of the total value of coins necessary to operate them, in accordance with the following schedules:

Machines vending merchandise

Coins not exceeding	**Tax**
$.01	$ .10
.14	.20
.15	.50
.25 and over	1.00

Machines vending services

$.01	$ .20
.02 and over	1.00

Statute of Limitations on Assessments:

Last year there was considerable discussion of the provision in the state enabling act to the effect that, except as to fraudulent returns, no assessment with respect to taxes imposed under local laws enacted prior to July 1, 1938, might be made after July 1, 1941, and that with respect to taxes imposed under local laws enacted after July 1, 1938, the period within which additional assessments might be made would expire three years from the date of filing of the return, if a return was filed. The limitation with respect to the assessment of additional taxes imposed under local laws enacted prior to July 1, 1938, was extended this year to July 1, 1942.[7] As a result, with respect to general business and financial tax returns due in 1939 or in prior years, with respect to sales tax and personal property tax returns due to and including July 15, 1938, and with respect to utility tax returns due up to and including July 25, 1938, the period within which assessments may be made now expires on July 1, 1942. With respect to returns filed after those dates and to all compensating use tax returns, the period within which additional assessments may be made expires three years from the date of filing of the return. However, such periods of limitation are applicable only if a return has been filed. Where no return has been filed, an assessment may be made at any time. If, for example, property were purchased without payment of a sales tax thereon, and were used in the City of New York, but no compensating use tax return were filed, or tax paid, the City might assess such tax at any time.

Exclusion of Federal Excise Taxes from Sales Tax Base:

The enactment of various excise taxes in the federal Revenue Act of 1941 gave rise to the question of whether the New York City sales tax should be computed on the selling price of an article inclusive or exclusive of the federal tax. By amendment to the sales tax regulations effective October 1, 1941, the City has ruled that if such federal excise taxes are separately stated and billed in addition to the selling price of the commodity, the New York City sales tax is to be computed upon the selling price exclusive of the tax. Where the federal excise tax is not separately stated, the City sales tax is computed on the gross selling price. Such regulation is not retroactive and no refunds will be made where the sales tax has been erroneously computed on a separately stated excise tax in the past.

This regulation while evoking considerable discussion is, generally speaking, of little importance. For where the federal excise tax is at the rate of 10% the amount of sales tax in question is only 1/10th of 1% or $1.00 per $1,000. That is to say, if a fur coat were sold at retail for $1,000.00 and was subject to the federal excise tax of $100.00 the New York City sales tax thereon would be $10.00 if the federal tax was separately stated, and $11.00 if it

[7] L. 1941, C. 200.

were not. The amount is indeed small and it is rare that the question will arise in the general conduct of business. While it is easy for the retailer to state separately a federal retail excise tax, it is extremely doubtful whether, if the federal tax in question is a manufacturer's excise tax, the retailer will even be in a position to state the amount thereof. Certainly he will be reluctant to do so, for the disclosure of such tax will reveal to the customer the amount of his mark-up. The City has ruled, however, that if the reduction in sales taxes is to be obtained, the federal excise tax must be separately stated.

Use of the Alternative Allocation Formula:

The City has recently issued a ruling extending the use of the so-called "alternative formula" for the allocation of sales in interstate commerce to New York City for business tax purposes. You are all familiar with the fact that in June, 1940, an optional method of allocation was made available to City manufacturers. Under this method, manufacturers may allocate their interstate sales to New York City to the extent of one-half of the cost of manufacturing and the expenses of selling. Such manufacturing and selling costs are limited however to two-thirds of the selling price. Because such costs in practically all cases are in excess of two-thirds of the selling price, the net result is that one-third of such sales in interstate commerce are allocated to New York. The advantage of this provision lies in the fact that City manufacturers are thus permitted to allocate a maximum of one-third of their interstate sales to New York City whereas without this option the amount to be allocated would range between the minimum of one-third and the maximum of two-thirds.

The City has now extended this option, definitely applicable where the entire manufacturing process is performed in New York City, to manufacturers who purchase raw materials and supplies, but "farm out" part and, at times practically the entire manufacturing or fabricating process to contractors, provided the goods are returned to the manufacturer's place of business in New York City from which point they are shipped to customers. The option is limited, however, to manufacturers and is not available to wholesalers or jobbers. The benefit of this allocation provision is not affected by the place of business of the sub-contractor and is equally applicable where the manufacturing process is "farmed out" to a contractor located outside the City or State of New York or to one located within the City.

Where a manufacturer has "farmed out" the manufacturing process to a contractor outside the City of New York and for business reasons some of the manufactured goods are not returned to the City but are shipped directly to customers from the contractor's plant, the taxpayer is denied the privilege of using the alternative formula for allocation with respect to receipts from such direct shipments. However, under these circumstances, he is permitted to allocate his receipts from interstate commerce sales on a combination basis using the alternative formula with respect to those goods shipped from New York City and the regular method of allocation with respect to those goods shipped directly from the contractor's plant located outside the City. A person who is engaged in the manufacturing business and is also a wholesaler or jobber of goods manufactured by others may likewise make an allocation of interstate receipts on a combination basis using the alternative formula for the receipts with respect to goods manufactured by him and the regular method with respect to receipts

from the sale of goods manufactured by others.

In the foregoing discussion I have used the term "manufacturer" rather freely without defining it. This was not an oversight but was due to the fact that the regulations are silent in this respect. The ruling to which I have just referred, while not precisely defining the term "manufacturer," does contain an indication of what constitutes "manufacturing." I should like to read to you the pertinent paragraph:

"Fundamentally, the term 'manufacturer' would include a person who, either directly or by contracting with others for the necessary labor or mechanical services, manufactures, fabricates or produces for sale or commercial use *from his own materials or ingredients* new or different articles, substances or commodities. The term 'manufacturer' would embrace a person who engages in activities of a commercial nature wherein labor or skill is applied, by hand or machinery, to materials so that as a result thereof new, different or useful articles of tangible personal property or substances of trade or commerce are produced. Such activities would involve the creation, fabrication or production of a product from raw materials, or the formation of a new and different product by combining two or more products. A mere change in an article resulting from treatment, labor and manipulation is not sufficient. There must be a transformation; a new and different article must emerge, having a distinctive name, character or use."

Exemption of Containers from Sales Tax:

The City has now conceded that sales by manufacturers of containers, such as wooden barrels, metal drums, packing cases, corrugated boxes, cartons and the like, are sales for resale and that the receipts therefrom are not subject to sales tax where the purchasers pack and sell their products in such containers. This concession is undoubtedly based upon adverse decisions rendered against the City by the Appellate Division and the Court of Appeals in the *Wood Packing Box Co.* cases.[8] In neither of the cases was an opinion rendered; but the decisions clearly indicated that the courts rejected the City's arguments that the packer made no separate charge to his customers for the packing materials and made no price differential in his merchandise on account of the packing; that the containers were used merely to facilitate transportation and not for the packaging of merchandise for sale; and, that the containers were usually destroyed in the process of opening and had little or no salvage value. These decisions followed earlier decisions in the *American Molasses Co.*[9] and *Sterling Bag Co., Inc.* cases.[10]

The City has not made the same concession with respect to wrapping paper, twine, labels, tags, etc. I understand that revised regulations with respect to the taxability of these items are in course of preparation.

Non-Taxability of Burglar Alarm Services:

In a case decided by the Appellate Division for the First Department only little more than a month ago[11] the City suffered a severe de-

[8] 262 App. Div. 720, Aff'd. without opinion—N. Y.
[9] 256 App. Div. 649, Aff'd. 281 N. Y. 269.
[10] 256 App. Div. 645, Aff'd. 281 N. Y. 269.
[11] Holmes Electric Protective Co. *v.* McGoldrick, N. Y. Sup. Ct., App. Div., 1st Dept., 10-31-41.

feat. It was held therein that the burglar alarm services rendered by the Holmes Electric Protective Co. did not constitute telephone or telegraph services as those terms are contemplated in the applicable sales and utility tax laws, and that the charges for such services were accordingly not subject to such taxes. It is pertinent to note, however, that the definition of "telegraph services" added to the utilities act on July 1, 1938,[12] specifically includes alarm services. The taxes in question in the aforementioned case relate to prior periods so that it is possible that such alarm service rendered thereafter may be subject to the utilities tax. However, on the basis of the decision they are not subject to the sales tax. In view of the large amount involved in this case, it is very likely that the City will appeal it and that the Appellate Division's decision is not final.

Assessment Based upon "Spot Check" Upheld:

I should like to call your attention briefly to the *Matter of L. Gandolfi & Co., Bankrupt,* decided by the United States District Court for the Southern District of New York last December. It was held therein that a sales tax assessment covering a forty-five month period based upon a "spot check" of a two month period was proper. The decision rested upon the fact that the law places the burden of proof upon the taxpayer to show that the assessment is incorrect and, in this case, that was not done. Most of you have run into situations where the City examining agent has relied upon a "spot check." If in the future you run into a situation in which an additional assessment is predicated upon a "spot check" which you feel is inaccurate, all steps necessary to convince the agent of the impropriety of his conclusion should be made at the time of his examination. In fact, I should like to amplify this recommendation and to suggest that in all instances where an examining agent proposes to make adjustments to which the taxpayer does not assent, every effort should be made to convince the agent of his error at the time of his examination, rather than resort to adjusting such differences at subsequent informal or formal hearings. If convincing evidence is available, it should not be reserved for a later hearing but should be used to reach a satisfactory settlement at the outset. Those of you who feel that such procedure is obvious may be surprised to learn that I was informed by a representative of the Emergency Revenue Division that it is not followed as widely as it might be.

Recent Utility Tax Decisions:

Dr. Tunick told you last year of the amendment to the New York City utility tax law imposing a tax on "vendors of utility services." This amendment, you will recall, was intended to overcome a decision of the Court of Appeals[13] in which it was held that the law prior to amendment did not cover landlords who sub-metered electricity. Dr. Tunick also reminded you of the requirements of the law that refund of taxes erroneously paid may be obtained only if a claim for refund is filed within one year from the date of payment and if the taxes in question were paid under protest. He also outlined a schedule of arbitrary bases of settlement under the old law which the City was following in instances where either or both of these statutory requirements had not been complied with.

Taxpayers who were not satisfied with these arbitrary settlements liti-

[12] Subsection 9 of Sec. Q 41-1.0 of Chapter 41 of the Administrative Code.
[13] 320 West 37th Street, Inc. *vs.* McGoldrick, 281 N. Y. 132.

gated the question. In *Corporate Properties Inc.* v. *the City of New York,*[14] the plaintiff was held to be correct in believing itself not liable to the New York City utility tax as a landlord sub-metering electricity current to tenants upon authority of the matter of *320 West 37th Street, Inc. supra,* the Court of Appeals decision to which Dr. Tunick referred. The court held, however, that the taxes had been paid under a mistake of law voluntarily and therefore denied recovery. In a subsequent case, *Sloane Estates, Inc.* v. *the City of New York,*[15] the plaintiff was likewise held not to be subject to the tax. However, since in this case there appeared to be an uncontroverted allegation that the payment was made pursuant to specific regulations of the Comptroller, the court held that the payment was made under duress and allowed recovery where the payments had been made under protest even though no timely claim for refund had been filed. The court held that the one year period of limitation within which a claim for refund must be filed pursuant to statute was inapplicable in this matter which was not brought under the statute but as a common law remedy. On the basis of these cases we may tentatively conclude that where a taxpayer seeks to recover by a common law action taxes paid under a mistake of law, such as the utility taxes in question, in lieu of following the statutory procedure (because of his failure to have met the statutory requirements of protest and claim for refund), he will be successful only if (a) payment of the tax was made under protest; and (b) if he is able to show that the payment was not voluntary. As the aforementioned cases may be appealed, the final word on this subject has not yet been spoken by the courts.

However, the recent amendment to the law making the utility taxes applicable to landlords sub-metering electric current as "vendors of utility services" has apparently received judicial approval in a recently decided case.[16] In that case the court sustained, without opinion, the City's claim that the plaintiff who submetered electric current to tenants during July and August, 1940, was subject to the utility tax.

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[14] N. Y. Sp. Term 8/29/40, 175 Misc. 306, 22 N.Y.S. 2d 539, aff'd (no op.) Ap. Div. N.Y.L.J. 5/17/41, p. 2221.

[15] N. Y. Sp. Term 175 Misc. 674, 24 N.Y.S. 2d 911, Aff'd (no op.) Ap. Div. N.Y.L.J. 5/17/41 P. 2221.

[16] 436 West 34th Street Corporation *v.* McGoldrick, Ap. Div. First Dep't, N.Y.L.J. 10/18/41.

Consolidation Rules of the Securities and Exchange Commission

By Thomas F. Thompson, C.P.A.

The Securities and Exchange Commission issued on February 21, 1940, a new regulation, designated "Regulation S-X," prescribing a uniform set of accounting requirements, which apply to most of the Commission's registration and report forms, for financial statements required to be filed under The Securities Act of 1933 and The Securities Exchange Act of 1934. Regulation S-X is subdivided into twelve articles, of which this paper intends to discuss the general rules governing consolidated and combined statements as included under Article 4. For practical purposes the regulation became effective for all financial statements filed on and after June 1, 1940.

The new regulation supersedes the several sets of accounting instructions which heretofore applied to the various forms. It governs the form and content of all financial statements to be part of:

(a) Form A-2 covering registration statements under The Securities Act of 1933.

(b) Forms 8-A, 8-B, 10, 11, 13, 14, 15, 17, 22, 23 and 24 covering registration of securities under The Securities Exchange Act of 1934.

(c) Forms 10-K, 11-K, 13-K, 14-K, 15-K, 17-K and 24-K covering supplemental or periodic reports under Section 13 of The Securities Exchange Act of 1934.

(d) Forms 1-MD and 4-MD covering supplemental or periodic reports under Section 15(d) of The Securities Exchange Act of 1934.

Article 4 of the Regulation S-X includes the general requirements for the preparation of consolidated and combined statements not only for commercial and industrial companies (covered by Rules 4.02 to 4.08), but also special requirements as to insurance companies, investment companies, bank holding companies, and banks (covered by Rules 4.09 to 4.12).

The following comments cover commercial and industrial companies. The forms usually filed by such companies are: Form 10—for the purpose of giving information relative to securities at the time of listing on a national exchange; Form A-2—to detail information in connection with the sale of securities; Form 10-K—to state currently, or bring up to date, the information originally filed under Form 10.

The general headings of the rules covering the preparation of consolidated and combined statements as they relate to the forms to be used by commercial and industrial companies are as follows:

Rule 4.02 — Consolidated statements of the registrant and its subsidiaries.

Rule 4.03—Group statements of subsidiaries not consolidated.

Rule 4.04—Statement as to principle of consolidation or combination followed.

Rule 4.05—Reconciliation of investment of parent in subsidiaries and equity of parent in net assets of subsidiaries.

Rule 4.06—Reconciliation of dividends received from, and earnings of, unconsolidated subsidiaries.

Presented at a special technical meeting of the Committee on Consolidations and Reorganizations, April 30, 1941, Carol F. Hall, Chairman.

Rule 4.07—Minority interests.

Rule 4.08—Inter-company items and transactions.

Detail Enumeration of the Rules

In enumerating the details of the above rules, the language used in Regulation S-X has been drawn upon freely.

Rule 4.02—Consolidated statements of the registrant and its subsidiaries:

The preamble to this rule indicates that the registrant shall follow in the consolidated statements, principles of inclusion or exclusion which will clearly exhibit the financial condition and results of operations of the registrant and its subsidiaries. There is, however, no rule issued by the Commission which says you must consolidate all subsidiaries.

In consolidation, however, the registrant is not permitted to consolidate any subsidiary which is not a majority-owned subsidiary.

In addition to the requirement that only majority-owned subsidiaries may be consolidated, there is another requirement to be followed, and that is, if the statements of a subsidiary are as of a date or for periods different from those of the registrant, such subsidiary may be consolidated only if all of the following conditions exist: (1) Such difference is not more than 93 days; (2) the closing date of the subsidiary is expressly indicated; (3) the necessity for the use of different closing dates is briefly explained; (4) any changes in the respective fiscal periods of the registrant and the subsidiary made during the period of report are clearly indicated, together with the manner of treatment.

Rule 4.03—Group statements of subsidiaries not consolidated:

For majority-owned subsidiaries not consolidated with the registrant, there may be filed statements in which such subsidiaries are consolidated or combined in one or more groups pursuant to principles of inclusion or exclusion which will clearly exhibit the financial condition and results of operations of the group or groups. If it is essential to a properly summarized presentation of the facts, such consolidated or combined statements shall be filed. Expressing the above in a slightly different manner, a consolidated or combined statement for majority-owned subsidiaries not consolidated with the registrant shall be filed if such a statement, in place of separate statements of these subsidiaries, is essential to a properly summarized presentation of the facts.

Rule 4.04—Statements as to principle of consolidation or combination followed:

This rule is intended to cover by notation in the respective statements filed, when applied to Rule 4.02 and Rule 4.03, the following:

(a) The principle adopted in determining the inclusion or exclusion of subsidiaries in each consolidated balance sheet or in each group balance sheet of unconsolidated subsidiaries; and,

(b) As to each consolidated statement and as to each group statement of unconsolidated subsidiaries, a statement in footnote form shall be made as to whether there have been included or excluded any persons not similarly treated in the corresponding statement for the preceding fiscal period, as filed with the Commission. If the answer to the foregoing is in the affirmative, the names of such persons shall be given.

This rule indicates that the registrant is required to add such information by means of footnotes to the balance sheets and profit and loss statements as will contribute to a full understanding of its financial condition and results of its operations, particularly if any change in

accounting principle or practice has been made during the period and such change substantially affects proper comparison with the preceding accounting period.

Rule 4.05—Reconciliation of investment of parent in subsidiaries and equity of parent in net assets of subsidiaries:

Very often the parent's investment in a subsidiary may be different from the parent's equity in the net assets of such subsidiary. To cover this condition, Rule 4.05 is all-inclusive, as follows:

(a) Consolidated subsidiaries.—There shall be set forth in a note to each consolidated balance sheet filed, a statement of any difference between the investment in subsidiaries consolidated, as shown by the parent's books, and the parent's equity in the net assets of such subsidiaries, as shown by the books of the latter. If any such difference exists, there shall be set forth the disposition made thereof in preparing the consolidated statements, naming the balance sheet captions and stating the amounts included in each.

(b) Subsidiaries not consolidated.—A statement shall be made of the amount of any difference between the investments of the parent and its consolidated subsidiaries, as shown by their books, in the unconsolidated subsidiaries for which statements are filed and the equity of such persons in the net assets of such unconsolidated subsidiaries, as shown by the books of the latter.

Rule 4.06 — Reconciliation of dividends received from, and earnings of, unconsolidated subsidiaries:

The proportion of the sum of, or difference between, current earnings or losses and the dividends declared or paid by unconsolidated subsidiaries that is applicable to the parent and its consolidated subsidiaries, shall be set forth in a note to each consolidated profit and loss statement.

Rule 4.07—Minority interests:

The minority interest in capital and in surplus is not to be stated in one lump sum, but is to be stated according to the rule prescribed, as follows:

(a) Minority interests in the net worth of subsidiaries consolidated, unless nominal in amount, shall be shown in each consolidated balance sheet. In such case, a separation shall be made between the minority interest in the capital and in the surplus; and,

(b) The aggregate amount of profit or loss accruing to minority interests shall, unless nominal in amount, be stated separately in each consolidated profit and loss statement.

Rule 4.08—Inter-company items and transactions:

In general, inter-company items and transactions, if significant in amount, shall be eliminated. If not eliminated, a statement of the reasons and method of treatment shall be made.

Discussion of the Rules

General comment:

As previously stated, the general rules enumerated apply to commercial and industrial companies.

If an examination is made of a substantial number of statements filed by such companies as part of Forms 10, A-2, and 10-K, it will be found that the majority of these statements conform with the general requirements governing consolidations. Such an examination will reveal, also, that a number of the statements filed have been filed under some of the options permitted by the Commission. In view of the fact, however, that a majority of corporations have already filed, and most likely will continue to file,

statements in accordance with the general rules, this discussion will be limited to such rules.

As most going concerns have already filed Form 10, any direct reference to forms will relate to Forms A-2 and 10-K. As we all know, the various forms have certain different periods to be covered in the statements submitted and different dates within which such statements shall be filed with the Commission. For example, profit and loss statements under Form A-2 are required for a three-year period, whereas Form 10-K requires the same statements for only one year. Similarly, the general rule covering the time within which Form A-2 is to be filed, is that the balance sheet called for shall be as of a date within 90 days of the date of filing with the Commission (although it may be filed within 180 days, if certain conditions exist), whereas the date of the balance sheet in Form 10-K shall be as of a date within 120 days of the date of filing with the Commission. As this discussion is not concerned with such differences, the comments that follow will deal with the general rules of consolidation to be observed in the forms filed.

Rule 4.02:

The first rule—4.02 "Consolidated statements of the registrant and its subsidiary"—is the most important basic rule to be followed. It is especially important to know what constitutes a subsidiary from the standpoint of inclusion or exclusion in consolidation.

As an over-all rule, no subsidiary may be consolidated which is not a "majority-owned subsidiary."

Using this over-all rule, three definitions will be given to illustrate what constitutes a subsidiary for the purpose of consolidation ("parent" and "registrant," when used, are one and the same person):

(1) The term "majority-owned subsidiary" is defined to mean a subsidiary of which securities representing in the aggregate *more than 50 per cent* of the voting power are owned directly by its parent and/or one or more of the parent's majority-owned subsidiaries.

In other words, the registrant in itself does not have to own more than 50 per cent of the voting power, as long as the registrant together with one or more of its majority-owned subsidiaries own in the aggregate more than 50 per cent of the voting power of any subsidiary. It should be carefully noted throughout that an accumulation of percentages of voting power of the parent's and subsidiaries' holdings can only be made when such subsidiaries of the parent are majority-owned. This percentage, whether accumulated or not, is required to be more than 50 per cent and not 49.98 per cent or just 50 per cent. If it is not more than 50 per cent, a consolidation shall not be made.

This rigid rule follows the theory that if the registrant does not own, directly or indirectly, more than 50 per cent of the voting stock, definite control is really not in the hands of the registrant. While one may say that control is often exercised with less than 50 per cent of direct or indirect ownership, recognized authority on this subject holds that no subsidiaries should be consolidated unless the parent owns over 50 per cent of the voting stock. Under ordinary circumstances such ownership carries with it the power to direct the management and policies of the subsidiaries, and is therefore considered as a prerequisite to the presentation of consolidated statements.

(2) The term "significant subsidiary" is defined to mean a subsidiary meeting any one of the following conditions:

(a) The investments in and advances to, on the part of the parent and the parent's other subsidiaries, exceed 5 per cent of the assets of

the parent as shown by its most recent individual balance sheet being filed.

(b) The assets of the subsidiary exceed 5 per cent of (1) the assets of its parent and the parent's subsidiaries as shown by the most recent consolidated balance sheet being filed, or (2) if a consolidated balance sheet is not being filed, the assets of the parent as shown by its most recent balance sheet being filed.

(c) The sales and operating revenues of the subsidiary exceed 5 per cent of (1) the sales and operating revenues of its parent and the parent's subsidiaries as shown by the consolidated profit and loss statement being filed for the most recent fiscal year, or (2) if a consolidated profit and loss statement is not being filed, the sales and operating revenues of the parent as shown by its profit and loss statement being filed for the most recent fiscal year.

(d) The subsidiary is the parent of one or more subsidiaries and, together with such subsidiaries if considered in the aggregate, constitute a significant subsidiary.

To illustrate this definition in general terms, it may be found that the investments in and advances to a subsidiary may not be in excess of 5 per cent of the assets of the parent, but as against this the assets of the subsidiary may be well over 5 per cent of the assets of its parent and could therefore make a considerable difference in the presentation of consolidated statements. Again, the profits of a subsidiary may be less than 5 per cent of that of the parent but its assets might be well over 5 per cent of the parent's assets. The converse of this situation could also be true.

(3) The term "totally-held subsidiary" is defined to mean a subsidiary:

(a) Substantially all of the outstanding securities of which are owned by its parent and/or the parent's other totally-held subsidiaries, and,

(b) Which does not owe to any person other than its parent and/or the parent's other totally-held subsidiaries any debt of an amount which is material in relation to the particular subsidiary; provided, however, that the existence of any indebtedness incurred in the ordinary course of business which is not overdue and which matures within one year from the date of its creation, whether evidenced by securities or not, shall not prevent a subsidiary from being deemed a totally-held subsidiary. This definition appears to be self-explanatory.

It should be borne in mind that even though a registrant may have investments which cover majority-owned or totally-held subsidiaries, they need not be included in any consolidation where such subsidiaries are not significant in relation to the total enterprise, in accordance with the definition of a "significant subsidiary." For example, a subsidiary may be owned to the extent of from over 50 per cent up to 100 per cent; but if its assets or revenues are less than 5 per cent of the total enterprise, they need not be included in consolidation. It should be noted that the regulations say *"need* not be included," which therefore gives an option to the registrant of either including or excluding such subsidiaries in consolidation.

A parent should watch its investments in other companies, especially if it does not want to become involved in the necessity of having to submit additional statements pursuant to the filing of Form A-2. Sometimes a corporation without any intention of control whatever may, through purchases over a period of years, have an investment in which it becomes a majority-owning holder of a significant subsidiary.

An actual known case of this type did occur to a certain corporation. The corporation did not realize that it held an investment in which it was a majority-owning holder of a security in a corporation engaged in an entirely different type of business than that of the registrant until it was in the midst of registering securities under Form A-2. It developed that it was a majority-owning holder to the extent of 50.77 per cent, which would not have been too serious but, as such a holder, it also came under the definition that it was a holder of a significant subsidiary because its investment in such subsidiary was in excess of 10 per cent of its own assets. Here was a case where the corporation had no intention of exercising control or directing the policies of the company in which it had invested. Its intention had been to obtain a good, sound investment which would yield a fair return. As a result, it proved rather costly to the registrant in presenting the statements required under Form A-2, in view of the fact that the subsidiary described was engaged in an entirely different type of business and could not, therefore—from the standpoint of clarity—be consolidated with the statements of the registrant. It was, therefore, necessary to prepare, in addition to the parent's consolidated balance sheet and profit and loss statements for like subsidiaries, a separate balance sheet and profit and loss statements of the subsidiary under discussion. The registrant's comment was, "Why didn't the responsible officers look into this situation before actually embarking on Form A-2, because if it had been known that we were a parent to this subsidiary we would have sold a few hundred shares of stock to bring our investment down to less than 50 per cent, and thereby no longer be a majority-owning holder."

In keeping with the above, it may be well to mention at this point that, under the instructions as to the particular items of the forms used (for example, Form A-2, Item 4(a)), it is necessary to list all of the subsidiaries of the registrant and to indicate the respective percentages of voting stock of each subsidiary company owned by the registrant or through any of the registrant's majority-owned subsidiaries.

The registrant is given latitude in answering this item. No subsidiary, whether domestic or foreign, need be named in answer to this item unless the subsidiary is of material significance in relation to the total enterprise as represented by the registrant and its subsidiaries. The test, of course, is whether such subsidiaries come within the definition of "significant subsidiary." However, the registrant is required to include in answer to this item the number of subsidiaries omitted, the total investment of the registrant in such subsidiaries, and the total sales and operating revenues of such subsidiaries omitted. It is provided further that, if any such subsidiary is a member of a group of subsidiaries performing essentially similar functions, and if such group of subsidiaries in the aggregate is of material significance in any of the respects of "significant subsidiaries," there shall be set forth a brief indication of the relationship of the registrant to such subsidiaries as a group and, if the number of such subsidiaries does not exceed ten, the names of such subsidiaries.

While the latitude above described is granted the registrant, it will be found, from a review of forms filed, that the majority of registrants list and name all subsidiaries and, by proper footnote, indicate which ones are significant and are not included in the consolidation for which separate statements are given, and which subsidiaries are not significant, and

for which no details are given, and the reasons therefor.

The Commission has also granted, upon specific request of the registrant, when filing Form 10-K for example, the privilege of consolidating subsidiaries without naming them due to the fact that the registrant does not want to divulge the name of such subsidiaries for the reason that it may prove detrimental directly to the subsidiary and indirectly to the registrant. However, in this connection, if a registrant exercises this privilege, there must be filed direct with the Commission that part of its annual report, to public disclosure of which objection is made, in a separate envelope marked "Confidential," and must be addressed to the Chairman of the Securities and Exchange Commission, Washington, D. C.

In addition to stipulating what constitutes a subsidiary for consolidation purposes, as discussed above, the Commission has specifically stipulated as part of Rule 4.02 that, if the statements of a subsidiary are as of a date or for periods different from those of the registrant, such subsidiary may be consolidated only if such difference is not more than 93 days. In other words, if the fiscal year of any subsidiary ends on a date different from that of the registrant, it may be consolidated if such difference is not more than 93 days. This is intended to cover industries whose interests are worldwide and where one to two months time may elapse before the parent company receives reports of the financial condition and results of operations for any given period.

Rule 4.03:

As previously stated, the Commission has not issued a rule requiring that all subsidiaries must be consolidated. For such majority-owned subsidiaries it has issued Rule 4.03 covering "Group statements of subsidiaries not consolidated."

This rule leaves it to the general discretion of the registrant as to how such statements of unconsolidated subsidiaries shall be filed. Whatever method is used, the registrant shall follow the principles of inclusion or exclusion which will clearly exhibit the financial condition and results of operations of a group or groups.

The rule is intended to cover the situations where some of the subsidiaries of the registrant may be in entirely different lines of business when compared with the registrant or when compared with each other. It is possible that several subsidiaries may be engaged in one type of business and several others may be engaged in entirely different types of business from the first group of subsidiaries. Therefore, in order for the registrant to properly present a clear exhibit of the financial position and operating results of itself and its subsidiaries, statements should be filed which will reveal the conditions of its own and directly related types of subsidiaries consolidated (covered under Rule 4.02), and also present consolidated or combined statements of the unconsolidated subsidiaries in a group or groups which will reveal the conditions of such respective subsidiaries. It may also be possible that the statements of one or more subsidiaries may have to be given separately where such subsidiaries have nothing in common with any of the others. It should be remembered that the subsidiaries considered shall be majority-owned and significant. Those which are not significant need not be considered, except by proper footnote as previously discussed under Rule 4.02 and as defined under "significant subsidiary."

A few words as to foreign subsidiaries should be included at this point, Such subsidiaries also come under the definition of "majority-owned" and "significant." The principle to be followed as to their inclusion or

exclusion is the same as for domestic corporations.

Due to present world-wide conditions, the determination of whether a foreign subsidiary shall or shall not be included in consolidation rests on the facts in each case. A perusal of some statements filed under Form 10-K, at the present time, shows that subsidiaries subject to war hazards, especially those located in Central Europe, are not being consolidated and separate statements are being filed. As to those not affected by war conditions, statements are being filed on a consolidated or combined basis. Under these circumstances it appears that a separate study is required as to the location of each foreign subsidiary to determine what subsidiaries shall or shall not be consolidated.

Rules 4.04 and 4.08:

In filing consolidated or combined statements, full disclosure of the principles and methods used are required. This is covered by Rule 4.04—"Statement as to principle of consolidation or combination followed."

The principles followed in determining inclusion or exclusion are to be covered in a footnote to the respective balance sheets and profit and loss statements filed. The registrant is allowed great latitude in choosing those methods of accounting, in consolidation, which will reflect most effectively and clearly the financial condition and results of operations of the registrant. The Commission does not indicate the methods of accounting to be employed, but in promulgating the above rule it does require that a clear statement of the methods followed by the registrant shall be included in a footnote in the statements filed. As a result of such footnotes it will enable the Commission to see for itself whether the methods used have been consistent and whether they are in keeping with good accounting procedure.

In considering the above, Rule 4.08 covering "inter-company items and transactions" may be included at this point because of its close relationship to the principles of consolidation. The rule indicates that, in general, inter-company items and transactions, if significant in amount, shall be eliminated and, if not eliminated, a statement of the reasons and the method of treatment shall be made.

Inter-company items and transactions calling for elimination in consolidation would usually be: inter-company accounts, inter-company profits, inter-company sales, inter-company dividends. The treatment of these items must definitely be stated in a footnote to the balance sheet and profit and loss statements. Good accounting practice indicates that all such items should be eliminated in consolidation in order to present an informative balance sheet and profit and loss statement. Inter-company accounts would cover all transactions between companies, such as loan advances, sales between companies, etc., which may not be paid for as they are made, repayment of loan advances, etc. Inter-company profits would cover inventories on hand which had been purchased between subsidiaries and should be adjusted to cost. Inter-company sales similarly should be eliminated so as to present true sales to outsiders. Inter-company dividends should also be eliminated so as to show true income from dividends from all outside sources. The footnotes covering these items must indicate that all such items have been eliminated in the preparation of the statements submitted.

Rule 4.05:

As a result of the operations of its subsidiaries, the status of the investment of the registrant neces-

sarily will change. Therefore, Rule 4.05—"Reconciliation of investment of parent in subsidiaries and equity of parent in net assets of subsidiaries"—has been issued to cover this situation. A corporation acquiring stock of another company may pay an amount equal to, greater than, or less than, the book value of the stock on the books of the company whose stock has been purchased.

Under these circumstances the Commission requires, as to consolidated subsidiaries, that there shall be set forth in a note to each consolidated balance sheet filed, a statement of any difference between the investment in subsidiaries consolidated, as shown by the parent's books, and the parent's equity in the net assets of such subsidiaries, as shown by the books of the latter. If there is a difference, there shall be further noted the disposition made thereof in preparing the consolidated statements, naming the balance sheet captions and stating the amount included in each. For example, if the amount of an investment in a subsidiary is greater than the book value of the stock purchased, the excess may be charged to the consolidated good-will account; if the amount of the investment is less than book value of the stock purchased, it may be credited to consolidated capital surplus, but specifically identified to show that it is a surplus arising from excess book value over cost of the stock purchased.

As to subsidiaries not consolidated, the parent has to indicate also by a footnote the amount of any difference in investment of the parent and its consolidated subsidiaries, as shown by their books, in the unconsolidated subsidiaries for which statements are filed and the equity of such persons in the net assets of such unconsolidated subsidiaries, as shown by the books of the latter.

Rule 4.06:

In continuation of Rule 4.05 above, Rule 4.06 logically follows to cover the "Reconciliation of dividends received from, and earnings of, unconsolidated subsidiaries." This rule requires the registrant to indicate by a footnote in the consolidated profit and loss statement, the registrant's and its consolidated subsidiaries' proportionate share of the sum of, or difference between, current earnings or losses and the dividends declared or paid by the unconsolidated subsidiaries. This requirement is pertinent for the reason that it will enable anyone to determine the total or net earnings of the registrant and all of its subsidiaries, by taking the consolidated earnings and adding or deducting the registrant's and its consolidated subsidiaries' share of the net profit or loss of the unconsolidated subsidiaries. This would be particularly important where unconsolidated subsidiaries may have suffered large losses, which losses might prove detrimental to the registrant's security holders especially when viewed from the standpoint of the dividend policy of the registrant. This note will also show, when taking the difference between current earnings less dividends either declared or received, the net current increase or decrease in the registrant's equity in its unconsolidated subsidiaries. Taken over a period of years it can be judged whether the investment in the unconsolidated subsidiaries has been beneficial or detrimental to the parent, and in the last analysis to the investor.

Rule 4.07:

The last general requirement, "Minority interests" (except for Rule 4.08 covering inter-company items and transactions which was discussed in connection with Rule 4.04), is designated as Rule 4.07.

For the purpose of clarity, es-

pecially where a minority interest may be substantial, this rule requires that the minority interests in the net worth of subsidiaries consolidated shall be shown in each consolidated balance sheet. Not only shall it be shown separately, but a separation shall be made between the interest in capital and in surplus.

In direct keeping with this information in the balance sheet there shall be shown separately in each consolidated profit and loss statement the aggregate of amount of profit or loss accruing to the minority interests. This requirement is basic in order to determine the amount of consolidated earnings applicable to the registrant and its consolidated subsidiaries; this amount can only be arrived at after deducting the amount of profits due to the minority interests.

Conclusion

As the general rules of consolidated and combined statements covered in Article 4 of Regulation S-X are studied and applied to the particular forms used, whether under The Securities Act or The Securities Exchange Act, they will be found to be very helpful, as the accounting requirements, as far as possible, have been made uniform. Necessarily, in making the requirements uniform, some additional information may have to be submitted in the financial statements of a particular form that was not previously required, but the additional information to be furnished will not be burdensome and will tend towards greater clarity.

In closing, it can be said that a concise summary of Article 4 under Regulation S-X may be expressed in the following words: "The registrant shall follow, in consolidated and combined statements, such principles of inclusion or exclusion which will clearly exhibit the financial condition and results of operations of the registrant and all of its subsidiaries."

Interest as a Claim in Corporate Reorganization

By PETER J. GEORGE, C.P.A.

INTEREST is an item which appears to be taken for granted by most business men. The importance can be shown in the Missouri Pacific Railroad Company case. Over a period of years, the interest on secured claims was allowed to mount to $150,000,000—a sum which was equal to the combined investment of the common and preferred stockholders. Had interest not been a factor in this case, it might have been possible for the stockholders to share in the reorganization.

In reviewing reports, books and legal periodicals, I have found very little written on the topic of "Interest in Corporate Reorganization," although various phases have been covered separately by many authorities. It is my intention to try to bring together these points on "Interest as a Claim in Corporate Reorganization." The topic is limited to the problem of establishing the claim up to the time of filing the petition and to the problem of establishing the claim during reorganization.

As corporate reorganization is of recent origin, we must resort to the equity receivership decisions as authority for many of these points. It is apparent, from the investigation made, that the theories followed under equity receivership were carried through Section 77B under the Bankruptcy Act of 1898 and finally in Chapter X of the Bankruptcy Act of 1938.[1] Since Section 77B and Chapter X do not mention interest, we must rely on the common law adjudications.

Definitions

The term "interest" has an early historical usage and can be found in Biblical writing as "usury." From early times, it met with much disfavor. Many attempts were made in vain to suppress the use of interest in business and in personal transactions. Through the passing of years, however, interest became growingly accepted as an implied custom of the day. It was not until the sixteenth century that negative legislation was passed in England to the effect that interest over and above the rate of 10% would be considered usurious. This statute did not specify, however, that interest up to 10% would be allowed. Custom would have it as such if business men desired to incorporate its use in their daily transactions. Interest was provided for, if expressly stated in contracts, to pay a certain sum of money on a fixed date, as in cases of bills of exchange, promissory notes and other marketable securities.

As time went on, the custom of paying interest grew to such an extent that it expanded to practically all contracts. It was about this time that legislation was passed affecting interest in tort cases.

In order to have a clear understanding as to the terminology used in this report, it is advisable that interest claims be defined from the

[1] An act to establish a uniform system of bankruptcy throughout the United States, as amended by the Chandler Act (Public #696, 75th Congress, 3rd Session) effective September 22, 1938.

Presented at a special technical meeting of the Committee on Consolidations and Reorganizations, April 30, 1941, Carol F. Hall, Chairman.

standpoint of what interest is and from where the interest rights arise, whether it be contractual interest, implied interest or legal interest.

"Interest is the compensation allowed by the law or fixed by the parties for the use or forbearance or detention of money."[2]

As may be implied from the above definition, interest is allowed by an agreement of the parties, expressly or impliedly, and the law imposes interest as a penalty for detention or forbearance of money. This has been substantiated in a New York Trust Company case, which stated "There are two classes of interest: one arising out of expressed contracts or implied contracts to pay it, and the other usually fixed by legislation in allowing damages for breach of contract or violation of duty."[3] It is important to bear in mind whether interest is allowed by agreement or whether interest is a penalty, because in many cases the period for allowing interest is different, as it may have a bearing on the rate of interest.

Contractual Interest

"Interest is created expressly when parties to a contract agree in terms that interest shall be paid, which is usually done in written contracts by inserting therein words, 'bearing interest,' 'with interest,' or words of that meaning. Where interest is reserved in contracts, it becomes part of the debt and is recoverable as a matter of right."[4]

Interest which is provided for by contract is the amount of money which will be recoverable upon the obligation, if the contract rate does not exceed the rate provided for in the statute so as not to make it usurious.

Implied Interest

Implied contract to pay interest may arise when the parties make no express agreement therefor, but from the circumstances the law may infer that they contracted with reference thereto, and interest may be recovered on this implied contract as if it were an expressed contract. The converse of this theory is also true, that no interest shall be paid. (Implied by custom.)

In order to recover interest under this implied contract theory, it is necessary to establish that there is a custom to pay interest. This custom must be legal, uniform, well known, long established and generally acquiesced. Where the custom is shown to be one generally adopted among merchants, the parties will be presumed to have knowledge thereof and to have contracted with reference thereto; but knowledge on the part of the debtor of a particular trade will not be presumed but must be established in order to raise the implication of a contract with reference to such usage.

Legal Interest

"Legal interest is that rate of interest prescribed by the law of the State or county which will prevail in the absence of any special agreement between the parties."[5] Lawful interest as distinguished from legal interest means any rate up to a certain rate specified by statute. The lawful rate of interest usually applies to agreements so that the expressed or contract rate will not exceed a certain percentage provided

[2] Henry Campbell Black, "Black's Law Dictionary" (West Publishing Company, St. Paul, Minnesota, 1933), Third Edition, pp. 996.

[3] New York Trust Company, et al. *v.* Detroit, T. I. Ry. Co. (CCA. 6th) 251 F. 514 (1918).

[4] 33 (C.J.) Interest, Paragraph 39.

[5] 33 (C. J.) Interest, Paragraph 4.

by statute, so as to prevent usurious interest contracts; whereas the legal interest is usually provided in statutes for the purpose of implying contracts of interest when none has been stated. The legal and lawful may be the same if the legal rate is not settled and the lawful rate is stated.

Nature of Proceeding

The basis upon which claims of interest are allowed for secured creditors against the general assets, will depend upon the rule used; that is, the Chancery Rule, Bankruptcy Rule, or the Equity Rule applied.

Chancery Rule: Under the Chancery Rule and under the rule refusing to calculate interest subsequent to appointment of receiver, a secured claimant would present his claim against the general assets for the original amount with interest up to the time of insolvency and appointment of receiver.

Bankruptcy Rule: Under the Bankruptcy Rule, the claimant would present his claim for the balance due after realization of his collateral with interest, up to the time of appointment of the receiver.

Equity Rule: The Equity Rule is that claims of any class are entitled to interest until the date of disposition if the assets of the estate prove to be sufficient to pay the claims of this class in full with interest. If the funds of the estate are not sufficient to pay these claims in full with interest, the respective interests of the creditors in this class are determined as of the date when the property of the debtor passed into the custody of the Court. In such cases, therefore, interest is allowed only to date of filing of the petition.[8] The Equity Rule, in the main, is used at the present time, and it will be further discussed in the text.

The Treatment of Interest Where No Express Contract for Interest Payment Exists

If there is no express agreement for payment of interest, then how can one recover interest on his obligation? Interest may be recovered when there is an implied contract or there is a statutory provision for the payment of interest. In either event, the problem of interest is treated as an expressed contract for interest after it has been decided that the item is interest-bearing.

An implied contract for interest has many ramifications, because there has not been an express agreement and the law must infer a contract from the circumstances. These circumstances involve the custom of the trade; whether it is well known; how long the custom has been established and whether it is generally acquiesced in. The main issue of the litigations which arises, is the question of intention of the parties.

The law has been made clear on many circumstances and situations over a period of time. These situations are now taking for granted that the transaction is interest-bearing. The problem usually arises when there is a dispute between creditors for their proportion of the assets. The problem is not very important if the debtor operates as a going concern without a reorganization or a bankruptcy.

These problems are governed by local law. A reorganization trustee may have situations where in one locality there is no such custom and in another locality there is. Accordingly, we have varying decisions and rules on the same set of facts. The Federal regulations are

[8] Gerdes. John—"Corporate Reorganization Under Section 77B of the Bankruptcy Act" —Vol. 2, Callaghan & Co., Chicago, Ill., 1936 pp. 973.

not a deciding factor in the question of interest, as the claim is decided upon the obligation which arose according to the law of the State where the contract was formed The interest problem is settled with the claim itself, and it is entered as one unit. To illustrate, a few will be considered.

In the Rice case,[7] the words "without interest from date till the payment becomes due" were used, and the Court ruled that an implication arose that interest will be payable after the date of maturity, because if the parties did not intend such a meaning they would have so stated. From the facts of this case, there must have been some understanding between them that a certain amount of money would have been paid on a fixed date, and that if it had not been paid accordingly then some compensation should have been made for lack of payment at the stipulated time. The Court had implied that the interest at the legal rate should have been paid after maturity.

In an Illinois case,[8] invoices were headed "Bills Bear Interest after Maturity. Terms 60 Days," and sent to customers at the time the goods were shipped. The Court held that this was sufficient notice of the custom in the trade and that it would be construed as a contract for interest after the 60-day period had elapsed.

In an English case,[9] the facts were similar to the above, except that the Court held that the statement was insufficient notice and no interest was allowed.

These cases are pointed out for the purpose of showing that implied contracts are governed by the circumstances surrounding the sale or contract.

In the majority of the cases, the theory behind the payment of interest has been that there was a breach of contract to pay money at a fixed date, and the interest is allowed as damages and not by reason of any implied contract to pay interest.[10]

The fact that interest is allowed on a claim from a certain date does not alter the amount if it is allowed as damages for breach of contract or implied contract for interest; but the question of proof has an important bearing as it is much easier to prove the contract has been breached by non-payment than to establish the implied contract for interest. That being a pure legal issue, not involved in the question of the claim for interest, it will not be discussed here, although it is of practical importance to be used in preventing interest problems in future dealings. The facts are usually determined before anyone is asked for an opinion or for advice.

Income bonds seem to be the largest interest-bearing item which is usually not provided for after maturity. If interest has been contracted for after maturity, of course, there would be no problem on the allowance of interest as a claim. Since there is no question on income bonds prior to maturity as the interest problem is provided for by agreement, it is, therefore, not mentioned here. However, if there has not been any agreement made as to the interest to be paid, then the Court must decide if interest will be allowed and, if so, at what rate. The Courts have held that interest will be allowed after maturity at the legal rate. This holding was discovered after checking carefully numerous bond cases. An attempt was made in vain to find cases dealing with interest on income bonds after maturity.

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[7] Rice *v.* Ahearne, 6 L.C. Jur. 201, 12 L. C. 280.
[8] Braun v. Hess, 187 Ill. 283, 58 N.E. 371, 91 AM. S.R. 221 (Aff. 86 Ill. A. 544).
[9] In Re: Edwards, 61 L.J. Ch. 22.
[10] Lincoln *v.* Claflin, 7 Wall, 132, 19 L. Ed. 106.

All income bonds that have been checked have been allowed at the contract rate, due to the fact that there was some provision in the bond to pay that specified rate until the bond matured. Apparently, the implied contract theory cannot be applied to such cases.

Income bonds have had an allowance for interest as a claim up to the date of distribution, regardless of the date of the petition and of the maturity date of the income bond before or after the petition.

In the Missouri Pacific Railroad Company reorganization,[11] the I.C.C. approved that income bonds, after the maturity date, shall be allowed the contract rate of 5% which was agreed to be paid prior to maturity, if it were so earned. In this particular case, the 5% interest rate accumulated from the maturity date (1935) to the effective date of the plan. The petition had no effect on these income bonds whatsoever. A petition of reorganization does not prevent the running of interest on obligations, as does bankruptcy statute which would stop the running of interest at the date of filing a petition.

Another illustration of income bonds which have paid the contract rate after maturity is the Kansas City, Memphis & Birmingham Railroad Company income 5's, due March 5, 1934. The interest rate on this obligation was 5%. Therefore, we can conclude that income bonds shall earn after maturity the legal rate if there is no provision for payment of interest; but, based upon actual checking, most income bonds have a provision for coverage until the obligation is paid, and that is the reason why the contract rate is carried after maturity.

Contract Payments and Loans: One who lends or makes advances is entitled to interest even though nothing is stated. This has been supported in many jurisdictions in very early cases, and has been so followed up to the present date.[12] The same theory is also true for all written instruments which call for the payment of money. Therefore, this would take in all the contracts which have payment of money as an obligation to the contract. The type of agreements involved in cases of that nature would be bonds, royalty agreements, leases in which the payment of taxes for the benefit of the tenant was involved, contracts for work, contracts for services, etc. In order to obtain a more complete list of cases, they may be found in 33 Corpus Juris Paragraph 62.

Open Accounts: Where it is the usage of the trade that interest shall be charged on an account after the expiration of a certain period and such practice is known to the debtor, interest will be allowed.[13] This rule is limited to the particular usage of the trade which is known and recognized by the debtor and creditor. The rule has no application after all dealings between the parties have ceased. In other words, after the debtor has paid his obligation and no interest was demanded, then no claim for interest can be made later.

In the railroad industry, claims have been allowed for interest on supply items which have been shipped on open account after maturity to the date of petition and after the petition was filed to date of payment.[14]

In the New York Trust Company

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[11] Missouri Pacific Railroad Company Reorganization, I. C. C. Finance Docket No. 9918, decided January 10, 1940.

[12] Pierce *v.* Rowe, 1 N.H. 179; Smith *v.* Bodine, 74 N.Y. 30; Stanley *v.* Franco American Ferment Co., 97 Misc. 401 161 N.Y.S. 365.

[13] Ayers *v.* Metcalfe, 39 Illinois, 307; Rayburn *v.* Day, 27 Illinois 46.

[14] Pennsylvania Steel Co. *v.* N. Y. C. Ry. (C.C.A. 2nd) 216 F. 458 (1914).

case,[15] interest for the period of receivership was not allowed on the six months' claim out of corpus where no diversion of income had taken place. Had there been sufficient profit during the receivership, interest might have been allowed on the six months' claim during receivership, although interest was allowed before the petition.

Cash dividends which have been declared but not paid will come within the classification that interest accrues from the date the obligation matures. It is a far-fetched type of claim, but it is still possible to be made.

If, in the event any of these obligations which I have enumerated above do mature after the petition has been filed, it is possible for interest to accumulate during the receivership, as interest is not terminated at the time the petition is filed as in bankruptcy. Also, interest will begin to run if the obligations mature after the petition has been filed. Of course, these are all subject to the rule that "claims of any class are entitled to interest until the date of distribution if the assets of the estate prove to be sufficient to pay claims of this class in full with interest."[16] This does not mean that the claim for interest until the date of the petition will not be allowed, as the Equity Rule stated above involves interest after the petition is filed.

Where interest is allowed by statute, it is usually imposed as damages for the breach of contract or duty. To illustrate, if an income tax payment is not paid when due, and there is an automatic accumulation of interest until paid, the rate and obligation is imposed by statute. The theory for the interest charge is that there was a breach of duty, and the withholding of payment must be compensated. The provision for interest can usually be found within the taxing statute.

Another familiar situation is where a judgment is obtained; then the law provides running of interest until the judgment is paid. In these cases, there is usually no issue unless there is a question of constitutionality of the statute.

Where a Contract for Interest Payment Exists

There seems to be no issue where a contract for interest is expressed, but the problem arises as to what rate shall govern if there is none stated. In such a case, the usual procedure is to use the legal rate of interest. If the situation arises where the contract is expressed and the rate is stated but the obligation is not met at maturity, then what is the problem? Is it the legal or contract rate which applies after maturity? If the contract were worded so that the contract rate shall be paid until the principal is paid, then the contract rate applies; or if another rate is provided for after maturity as long as it is not a usurious rate, then the contract will govern.[22]

In the Sears case, interest on past due bond,[23] payable in Massachusetts, was recoverable at rate fixed in the bond. There was a stipulation which could be construed to mean that the contract rate would apply until the principal was paid. An additional factor was raised here on negotiable coupons; that they bear a legal rate of interest after

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[15] New York Trust Co. *v.* Detroit T. & I. Ry. Co. (1918) 251 Fed. 514.

[16] Gerdes, John, "Corporate Reorganization under Section 77B of the Bankruptcy Act." Volume 2, pp. 973.

[22] Scottish-American Mtge. Co. *v.* Wilson 24 Fed. 310 (1885); Agency of Canadian Car & Foundry Co. *v.* American Can Co. 258 F. 363, 169 C.C.A. 379, 6 AFR. 1182 (reversing decree D.C. 1918) 253 F. 152.

[23] Sears *v.* Greater New York Development Co. (1931) 51F (2d) 46, affirming (D.C.) 19F (2d) 654 and certiorari denied 52 S.Ct. 42 284 U.S. 668, 76 L. Ed. 565.

maturity. A problem of this nature is governed by the local law of the place where payment is to be made on the bonds.

Let the facts be moved to the extreme. A contract rate is provided; the maturity date has been reached; and there is no provision for interest rates after maturity. What is the result?

In answering the above problem, it is best to illustrate with a series of cases:

In the Brewster case,[24] a party gave two promissory notes. In one, the term was twelve months; and in the other, the term was six months. The rates were 20% for the first note, and 2% per month for the second note. Upon default, the holder sued and recovered the contract rate before maturity, and the legal rate after maturity.

In the Alabama case in 1932,[25] the Court held that where the contract fixes the rate of interest generally or until maturity, legal rate is due after maturity.

In Kentucky—a case in 1928[26]—the Court held that where a vendor's lien notes stipulated 8% interest until maturity, they are entitled to only 6% after maturity of respective notes, not to 8% until maturity of the last note.

In New York it is well settled that the contract rate of interest governs to maturity and the legal rate of interest after maturity. In the Pryor case,[27] the Court said: "It seems to be the general rule of law that the rate of interest is fixed by the contract to pay money up to the time of default; but after breach, the rate of interest is determined not by the contract but by statute".

Whereas this principle is followed in the Syracuse case in 1933,[28] the Court clarifies the situation further by stating: "The mortgage was due and payable, as to its principal sum, on August 1, 1929, and its payment could be enforced after that date without any declaration of default. If the conversation claimed to have resulted in an extension of time for payment of the principal sum due had brought about that result (and we hold that it did not), it was nudum pactum for the reason that it was not based on any consideration for, after August 1, 1929, the mortgage bore 6% interest by statute." It is well settled that after the maturity date the obligation carries legal rate of interest.

Some of the reasons given for this rule are:

1. Contract rate is allowed to maturity by virtue of the contract, whereas, the legal rate applies as damages for breach of contract.
2. There is no rule of law that the contract is implied after maturity at the contract rate.
3. If the parties wanted the contract rate, why did not they provide for it until payment?

This reasoning is followed by the great majority of States. Every case which I examined always had some circumstance within which one could read a contract after maturity.

There is the question of acceleration which brings an obligation to maturity date, and a default in payment is then followed by damages for not meeting the obligation at maturity. The point is well illustrated in the Equitable Trust Co. case[29] on recovery of damages for breach of contract to pay money.

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[24] Brewster *v.* Wakefield, 22 How 118 16 L. Ed. 301 (1859).
[25] Davis *v.* Anderson, 140 So. 423, 224 Ala. 400.
[26] Fergeson *v.* Guess, 1 S.W. (2d) 1041, 222 Ky. 646.
[27] Pryor *v.* City of Buffalo, 197 N.Y. 123 at page 143 90 N.E. 423 at 429.
[28] Syracuse Trust Co. *v.* First Trust & Deposit Co., et al, 239 App. 586 267 N.Y.S. 867 at 867-8.
[29] Equitable Trust Co. of New York *v.* Western Pac. Ry. Co., 244 F. 485 judgment affirmed 250 F. 327, 162 C.C.A. 397 and certiorari denied in 38 S.Ct. 423, 246 U. S. 672, 62.

The interest recoverable after default in New York is the legal rate, regardless of the contract rate before maturity.

In some States where the legal rate of interest is high, there have been statutes passed to prevent one from increasing the rate after default or maturity date. This was done to prevent the mortgagee from using the blanket default mortgages when operating in nation-wide business. This is illustrated in the Investors' Syndicate case[30], wherein was applied a statute that the highest rate of interest permitted after maturity under contract providing for payment of interest before maturity was the rate of interest which was charged before maturity (Mason's Minn. St. 1927. 7036).

In the New York Alaska case[31], the statute involved allowed 8% interest on all money after due date[32].

In conclusion, the legal rate is the rate applied if there is no agreement for payment of interest after maturity. This rule is followed whether before the petition for reorganization is filed or after the petition is filed, as the petition for reorganization has no bearing on the issue.

Security Insufficient for Secured Claimant

After having decided that a claim for interest is permissible, assume one step further: that there is a contract to secure principal and interest. It is understood that there would be no problem if the assets were sufficient to pay this secured class; but if the assets were insufficient as security, how does the balance of the interest claim appear as a claim? Is the interest paid first? And does the balance of the principal appear as a claim?

The general rule is, that interest on bonds has no priority over the principal debt but shares equally with it[33]. Therefore, if the claim is made as a unit—principal and interest accruing to the date of the filing of the petition, the security being insufficient to recover fully on the claim—no interest can be allowed while the estate is in the hands of the Court. The reason is, that the interest is allowed during a receivership only when there is a sufficient estate to pay the class in full with interest[34].

The facts, as they now stand, are that interest is allowed to the date of the filing of the petition, and the security is insufficient to pay the principal and interest in full. The claim could have been entered for the full amount against the general unsecured assets and could have shared with the general unsecured creditors; then it could have realized on its security. But this was under the Chancery Rule. Under this plan, anything in excess of 100% of the claim had to be refunded to the receiver. To illustrate:

A owes B $100, and B has security which is equal to $50. A's estate, which is in receivership, is paying 70% of the general unsecured claims; therefore B filed the claim for $100 and received $70. The balance of $30 is available from the security, and B must return the $20 which is the excess over $100.

Under the Bankruptcy Rule, the secured creditors cannot participate in the general unsecured assets until the security is realized upon or an allowance is taken for the security. Assuming the same facts as in the

[30] Investors Syndicate *v.* Baskerville Bros. Holding Co., 274 N.W. 627 (1937).
[31] New York Alaska Gold Dredging Co. *v.* Walbridge 38 F. (2d) 199 (1930).
[32] Camp. Laws Alask. 1913, paragraph 684 as amended by Laws Alaska 1913 c17.
[33] Real Estate Trust Co. *v.* Union Trust Co. 102 Md. 41, Atl. 228 (1905).
[34] Board of Commissioners of Sweetwater County, Wyo. *v.* Bernardin, 74 F. (2a) 809, (C.C.A. 10th 1934) certiorari denied 55 Sup. Ct. 645 (1935).

above illustration, B would file the claim for $100 less the $50 security, which results in a $50 claim. This is a net claim which is fully unsecured. The unsecured claimants are receiving 70%; therefore B gets $35 for the unsecured portion. B would realize only $85 on this method whereas, under the Chancery Rule, B would realize $100.

In checking Chapter X of the amended Bankruptcy Act of 1938, Section 197, there seems to be the leaning toward the Bankruptcy Rule as the section provides ". . . to determine summarily the value of the security and classify as unsecured the amount in excess of such value." This is an observation made only from the statute and from one or two reorganizations which have followed that theory; but there has been no adjudication on this point. The Bankruptcy Rule is fair and should be followed, as the unsecured creditors should be treated alike and no discrimination should be made.

Let the facts be altered by having security for the principal only. Then what is the situation of the interest claim?

If the creditor has no such lien covering his interest, he cannot make a claim against the security; but he must enter the claim as unsecured and share in the general unsecured assets.

What Effect if the Security Is Another Secured Obligation of the Same Company?

A good illustration for the problem is the Interborough Rapid Transit Company's 7% convertible gold notes, due September 1, 1932, which company has 165% of first refunding gold 5's due in 1966 as security. At the maturity date of the notes, the principal and the last six months' interest were due. After several years of litigation, the Court ordered, on December 3, 1935:

1. That an amount sufficient to pay interest at the rate of 7% on unpaid balance should be paid first.
2. That the remainder should be applied as a reduction of such unpaid balance[34A].

The results are, that no interest is being paid directly by the company on these notes, but the company is meeting the interest on the first refunding 5's. This interest is used by the trustees to liquidate the interest on the unpaid balance and to liquidate the principal. Up to July 1, 1938, $516.90 has been distributed, and it has been applied according to the court order of December 3, 1935—$399.46 for interest, $113.50 on the principal of the note, and $3.94 on the interest due September 1, 1932. In 1939 interest has been stopped on the collateral, therefore there is no liquidation pending the New York City purchase of the I. R. T.

The principal is well settled that the payment of interest during receivership, if it is to be paid, is to be paid first and the balance will be used for the principal[34B]. The questionable factor is the interest on the coupon due on September 1, 1932 (7% interest). If an item is not paid at maturity, the legal rate is paid. The issue does not seem to be raised, as the discussion is on whether the coupon should receive any interest at all.

My opinion is that interest may be recoverable on the coupon, but only at the legal rate, and the same is true on the notes, unless the note contract is to the contrary. In this case, it does not seem reasonable that 7% should be allowed on a coupon, as the theory upon which the action can be brought is a breach of contract and the damages are

[34A] Moody's, Public Utility Manual 1938 at p. 2211.

[34B] Ohio Savings Bank & Trust Co. *v.* Willys Corp., (C.C.A.) 8 Fed. (2d) 463, 44 A.L.R. 1162 (1925).

based on the legal interest rate. In order to recover 7% it must be in the contract, or implied in the contract. It could not be in the contract as no litigation would have arisen, and the interest could not be implied on the past due coupons.

To summarize, the collateral of same company can be used to pay off principal and interest, but interest accumulations during the receivership are paid first. The question of rate after maturity has been previously discussed and summarized in prior pages.

The Economic Effect of Accumulating Interest on Bonds

Interest has become a very important topic since the Los Angeles Lumber Products case[39], as this case upheld the Boyd case in which the Court held that no junior claimant should receive any value until the senior claims have been fully recognized. By this move, the interest claims are being respected, as it now brings about the question of the junior security holder's interest. Interest was treated lightly in the past, as the creditors would compromise various claims and thereby lose the effect of interest as a claim.

To illustrate this, the Newark Athletic Club had a reorganization, and a life insurance company was holding a bond secured by a first mortgage, which bond with past due interest amounts to approximately one million dollars. But, during the trusteeship, the insurance company agreed to take approximately $750,000 for its claim with a first mortgage; but the junior security—namely, the debenture bondholder—complained of the 10% allowance for the debenture bonds. Therefore the debenture holders brought an action in order to obtain a larger sum. While the case was pending, the Los Angeles case was settled, and the debenture holders were forced to drop their case. They are now wiped out, and there is not sufficient value for the bond and past due interest. This has strengthened the insurance company's position and they are entitled to approximately all the assets of the estate. The delay has added several years' interest on the bond, and that increased the senior position to a point where there was no junior equity.

The illustration is brought forth for the purpose of establishing that the bondholders today are in a stronger position than they have ever been prior to adoption of Chapter X of the amended Bankruptcy Act in 1938.

Interest could mount to large sums—as it did in the Missouri Pacific case. The amount in that case was $150,000,000, which was equivalent to the preferred and common stock interest.

It is to the interest of the stockholders to see that the interest is paid on bonds currently, to prevent the reduction of their equities over a period of time. Also, it is to the interest of the stockholders to have the reorganization rushed, as the bondholders accumulate more fixed charges thereby reducing the stockholders' equities. This is clearly shown by various reorganizations which have taken five, six and ten years to liquidate or readjust their positions.

The point is well taken in railroad reorganizations which have taken and are taking years to reorganize; but the Los Angeles case will have some bearing in rushing them. If the company is not operating at a profit or covering the expenses of the fixed charges, time will cause a financial suicide to the stockholders whether they be preferred or common.

After the Los Angeles Lumber case, a sudden increase was appar-

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[39] Case et al *v.* Los Angeles Lumber Products Co. Ltd. 308 U.S. 106 (Nov. 6, 1939).

ent in the buying of senior position bonds which were under reorganization. This is an encouraging factor, as the investors recognize the value of a secured obligation. The benefit will be available to the investors and to the borrowers. The investor wants security and the borrower wants to pay a low interest rate. The reduction of risk means the reduction of the rate of interest, and the desire to loan at a fair rate.

The economic effect is summarized as follows:

1. The bondholder's position has been greatly improved after the Los Angeles case.

2. The investors have come forth and have bought many issues which have senior positions in the reorganization.

3. The new reorganization[36] section has been a great help to the bondholders in strengthening their position and eliminating junior equities. This is brought about as the asset valuation shrinks, or the senior position increases (by non-payment of interest).

4. The increased importance of the interest claim is now recognized. Although the interest claim has been recognized in the past, the claim would be given a subordinate and junior position to the one had before the reorganization. Since the Securities and Exchange Commission has been submitting criticisms to plans they have improved the position of the bondholder under the Fair and Equitable Rule[37].

5. Reorganizations will have a tendency to speed up and encourage quicker settlement of issues, as the junior security holders feel the pressure now.

[36] Chapter X—Bankruptcy Act as amended.
[37] New provision in Chapter X of the Bankruptcy Act as amended in 1938.

THE AMERICAN RED CROSS NEEDS THE HELP OF THE ENTIRE ACCOUNTING PROFESSION

The Accountants Committee for The Red Cross War Fund would like to hear from you

Consolidation of Foreign Subsidiaries

By H. C. M. Cobb, C.P.A.

"FOREIGN Subsidiaries"—these words are beginning to have a strange significance to people in business today. In normal times, these were companies which had the opportunity to do a thriving business, making an excellent investment for an American parent company. The investor looked upon these as a source of expansion for his company, new fields to earn profits on his dollar. American companies since the turn of the century have invested millions of dollars in foreign countries and, each time the profits started rolling in, there were upheavals in various parts of the world so that, instead of having foreign subsidiaries, we often had foreign hazards.

These millions of dollars have been invested in practically every country of the world, so that American business influence has become a great thriving factor in world affairs, and these widely spread investments have for many companies come to form a major part of their total assets. Consequently the investor is vitally interested in his company's activities abroad, and the officers of the company are anxious to show that they are doing a good job of doing business in foreign (not always too friendly) lands.

Since the last so-called "World War," this development of foreign business has been particularly active; business got its first blow with the still-ensuing war in China—a country where very substantial investments had been made.

This was not enough, and was shortly followed by the Spanish War and then, as a final "bombshell," the present so-called "Second World War," which seems to be spreading almost daily to new territories.

War in Spain and, at the beginning of this new conflict in Poland, Norway, and a few of the smaller countries, had little appreciable effect on the American investor. But soon the theatre spread to larger countries until we in America began to view with alarm the fate of our many millions invested abroad, and began to wonder where the axe (or maybe I should say the "Axis)" would strike next; until today, when a large portion of the world is already involved and the rest is likely to be so in the very near future, war conditions are our everyday spectre.

Naturally all these incursions into the peaceful flow of business worried those companies with foreign investments and correspondingly worried the investors; so accountants, who are always worrying about something, had this new worry added to their already long list. How were they to treat foreign companies in the preparation of statements, and what were they to advise their clients to say about them, so that the investor could obtain readily a true picture of the assets, liabilities and operations of his company and the relationship of its foreign subsidiaries thereto?

In facing the problem of treatment of foreign subsidiaries, there are certain factors to be considered before we can make any basic decisions:

1. We must know the comparative importance of the foreign subsidiaries in relation to the group as a whole.

2. We must ascertain the local

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conditions surrounding the operation of each foreign company.

3. We must consider the type of organization of each company.

When we have ascertained these facts we then have to make a choice as to whether to present statements consolidating the assets, liabilities and operations of foreign subsidiaries with those of its American parent and domestic subsidiaries, or merely to show the parent company's investment therein. Secondly, we have to consider the treatment of our choice in its own particular light.

We are not going to concern ourselves with the treatment of investments as such, but we might consider briefly the factors which might lead us to make a decision on the question "To consolidate or not to consolidate?":

1. The importance of the subsidiary in relation to the group as a whole.—Other conditions being equal, the problem of presenting small unimportant subsidiaries which have no appreciable effect on the picture as a whole is correspondingly unimportant and so may be stated as an investment without arousing any criticism. However, the inclusion of important subsidiaries as investments usually arouses comment unless the reason therefor can be readily explained.

2. The local conditions surrounding the company's operations: We must ascertain the status of the country in which the subsidiary operates; whether it is at war or peace. War and general unrest bring many things in their wake to hinder a company's business. Plants may be requisitioned for conversion to other lines of business; they may be seized or even destroyed. Transportation difficulties may completely hamper operations. Governments may impose currency restrictions which would prohibit the transfer of funds and make the realization of profits practically an impossibility. Mails may be so delayed that reports on assets, liabilities and operations may only be available at a date too late to be of any use in showing proper consolidated figures.

3. The type of organization: We must consider whether the company is an operating, non-operating, selling or manufacturing company, and what type of business it is in; whether it is a steel company, entertainment company, service company, etc.

A brief review of reports of companies during the past year shows somewhat diverging choices on consolidation and investment treatments. This is due, in the main, to war conditions, which naturally have different effects in various countries and industries. However, on the whole, certain points seem to prevail in the choice of each, other factors being equal:

1. Foreign subsidiaries in disturbed areas where war conditions prevail and where currency restrictions of some sort are prevalent, are not consolidated. Subsidiaries in other countries are consolidated.

2. Subsidiaries in foreign countries from which reports are not readily available but which can be obtained in reasonable time are consolidated, with a note as to the date of the statements so consolidated.

These are just a few of the points, as opinion diverges even in these respects; proper disclosure should be made of each fact surrounding the choice and basis of presentation.

As an illustration of how the local conditions surrounding the company's operations and its type of organization may affect a choice of presentation, let us consider two companies operating in the same country—one purely a selling company, the other a manufacturing company. The first does not have half the problems in consolidation that the other may have. The manufacturing company

probably has a large portion of its assets tied up in plant and equipment—which is very hard to liquidate in emergency—and, except for land values, probably does not represent anything like its true value except as a fully operative concern. The selling company has little to contend with in this respect.

One company may have been fortunate enough (they may have thought it unfortunate at the time) to have indebtedness incurred abroad guaranteed by the American parent company; so that even if their profits abroad become frozen they can virtually unfreeze them by paying off this indebtedness and thereby take the responsibility off the parent's shoulders.

Here, however, we are primarily interested in consolidations as such, so let us consider our choice made—and we are going to have consolidated foreign subsidiaries. Let us first look at the possible form in which we may submit statements of this nature so as best to show a true picture of the consolidated group.

This may be done in several ways, of which the following are suggested:

1. To furnish complete consolidated statements and, in addition, submit in suitable form a summary of the foreign subsidiaries' assets and liabilities and their profits and losses, and the parent company's equity therein.

2. To furnish complete consolidated statements and consolidated statements for domestic companies only.

3. To furnish consolidated statements where domestic and foreign companies are shown separately and also consolidated.

4. To furnish complete consolidated statements and submit in addition parent company statements showing the investments in, and income from, foreign subsidiaries.

Let us consider these various treatments and see what they represent and what effect they may have. This, after all, is the primary consideration—the mechanics of consolidation can come later, as in the preparation of any statements, thought as to the form of presentation comes long before the mechanics of the work are completed.

First, in our consideration we have the complete consolidated statement and, in addition, a summary (in suitable form) of the foreign subsidiaries' assets, liabilities and operations, and the parent company's equity therein. This is becoming a popular form of presentation where the foreign situation can be seen very clearly.

To elucidate this still further, a number of companies now break up this summary into geographical locations, so that the reader can picture at a glance where the danger, if any, may be, and if there is any, how much it may cost him. The parent company's equity in those companies is helpful in this respect. How much accent does this place on the picture?—It places the good and weak spots very clearly, but they may be unnecessarily accented if the assets in question do not merit such a distinction.

Now let us consider the second method: that of presenting complete consolidated statements, and statements for consolidated domestic subsidiaries. This merely accents the foreign picture by its partial absence. It leaves the reader to wonder what it may consist of. So it cannot be too important—or it should not be. Then, if proper disclosure is made, either the foreign investments are negligible in importance, or they are in the non-consolidated category so that our picture is not distorted.

The third choice is that of threefold consolidated statements showing total, domestic, and foreign separately and combined in one state-

ment. This is another well-tried method of presentation used by several of the larger companies. This does not accent any particular company in the group, but does show very clearly the comparison of domestic and foreign subsidiaries in relation to the total, so that the reader can see at a glance what portion of each item on the statements contains foreign items, and how much.

Lastly, we have the treatment of presenting consolidated statements, and parent company statements, showing the investment in, and income from, foreign subsidiaries. This method puts the least accent on the foreign picture and is a milder picture of the first treatment suggested.

Now let us consider some of the mechanics of consolidation and some of the problems we have to consider.

Naturally, in preparing any such consolidation, the assets, liabilities, and operations of the foreign companies have to be converted into United States dollars. I think that it has become generally accepted practice to convert these in the following manner:

1. Fixed assets at rates prevailing at dates of acquisition.
2. Other assets and liabilities at current exchange rates.
3. Operations at average rates for the year, quarter or month.
4. Capital stock and surplus at rates prevailing at dates of acquisition or organization.

This, of course, leaves an excess or deficiency, which may be handled either by an adjustment through parent company surplus or by an adjustment in the consolidation only through consolidated surplus, but not specifically reflected in the figures of any one of the group.

Secondly, we have the problem of specific reserves for future contingencies. This is something which is very hard to estimate under existing conditions in some countries; however, in collaboration with the company's executives, we are duty-bound—based on past experience and delving into the realm of possibilities—to make some estimates. This may be handled in the same manner as the exchange differences mentioned before.

Thirdly, we have the inclusion of income from sources where general unrest is rife. The general practice in this respect has been to take up as income only that portion which is readily realizable in U. S. dollars. Thus if upon consolidation it is felt that the profits of the foreign subsidiary are not fully realizable in U. S. dollars, proper reserves should be provided to show true income earned.

These are only a few of the considerations but represent the most important ones. So let us now consider what we are going to say about all of those things in explanatory notes to the consolidated statements.

Firstly, the basis of consolidation should be indicated, and what companies or geographical group of companies have been eliminated and why. Secondly, the basis of the conversion of the foreign statements into U. S. dollars should be stated. Thirdly, the dates of the statements of any companies included at dates other than that of the parent should be given. Fourthly, disclosure of any irregularities of procedure due to the exigencies or the local conditions of the company should be made. In some cases, high rates of depreciation are being used in contemplation of conservative operating results during periods of unrest. Profits in some cases have been used to acquire major plant facilities or to repay indebtedness.

Each note, in its own light, should explain the whys and wherefores of chosen treatments and bases.

At this point we have all our fac-

tors, method of presentation, mechanics, facts, and our notes on each. Now we can divorce ourselves from all of it and look at it as a whole—as if we were the investor trying to understand it all.

Does it portray a true picture of the facts in their related importance? Will it give him what he wants, even though he may or may not like what he sees? If it does, and we have made clear for him the tangled maze of international business accounting (with which he probably has only a slight familiarity), our job is done.

REMEMBER PEARL HARBOR!

BUY DEFENSE BONDS

Procedure in Audits of Insolvent Business Organizations*

By SAMUEL KRIEGER

WHEN a business organization finds itself in financial difficulty and unable to meet its maturing obligations, the creditors will often take steps to determine the debtor's financial condition. Then they will decide whether or not the debtor should be allowed to continue in business, and if so, on what basis.

This paper will discuss the audit procedure to be followed to determine the present financial status of the debtor. The final result of such an audit is the report presented to the creditors, in which not only is the debtor's financial condition shown, but also the efforts made by the auditor to ascertain whether any fraud affecting the insolvency was committed. The possibility of the granting of preferences is also discussed in such a report. These factors will help the creditors to determine the good faith of the debtor and will influence their decision as to the future of the debtor's business.

For the sake of convenience and clarity, the procedures suggested to determine (1) the present financial condition and the cause of the financial difficulty, (2) whether the last financial statement issued was fraudulent or not, and (3) whether there was any fraudulent withdrawal of assets from the business, fraudulent concealment of assets or fraudulent preference of creditors, are each discussed in separate sections. It is not meant to imply thereby that one part of the investigation can be segregated from the rest, or that the procedures for accomplishing these purposes should necessarily be taken up in the order in which they are discussed in this paper. Each element is an integral part of the investigation and is often dependent for its value on the other elements.

Unfortunately, as most auditors know, the temptation simply to follow set directions and forms in carrying out an audit is great, and occasionally prevents the discovery of fraud or the achievement of some other purpose for which the audit was made. The audit program suggested herein is meant more as a guide than as a hard and fast rule. Like all other such programs it should be varied with the individual case, depending on the type and size of business involved and on what the auditor finds after he starts his investigation.

What Is the Debtor's Present Financial Status and What Caused the Difficulty?

Definition of Insolvency

Before discussing the procedure to be followed in answering the above question, the term "insolvency," as used in this paper, will be explained. According to the National Bankruptcy Act (Chapter I, Section I, Paragraph 15), a business is insol-

* *A thesis presented to the faculty of the Graduate School of Business Administration, New York University, in partial fulfillment of the requirements for the degree of Master of Business Administration, 1941.*

vent, "when its property at a fair valuation is not sufficient to pay its debts." The equity of the owners has been wiped out and the liabilities of the business are greater than its assets.[1] However, the term is often used in a much broader sense to signify a condition which exists when, in the ordinary course of business, ready funds are not available to meet maturing obligations. This scarcity of funds may be caused by continued heavy losses from operations, by unwise investment in excessive plant or property, thus permanently tying up funds which are needed to pay current obligations, or by excessive dividend payments or other excessive withdrawals of capital. In this paper, the term will be used in this latter meaning—denoting an inability to meet current obligations as they mature.[2]

Inventory of Books and Records

In starting his audit the accountant should first make a list of the debtor's books and records (including old financial statements, copies of income tax returns, schedules, inventory sheets, cost records, bank statements, etc.), which are on hand. With this list he will know where to find the information he is seeking. If any important books are missing, a search should be made on the premises of the debtor to see whether they can be found. Rarely are these books lost, but occasionally they are hidden in an attempt to conceal some facts from the creditors.

In a report published by the Irving Trust Company in 1932, they said, "In many instances it is found that the bankrupt has kept no financial books or records at all, or perhaps only a cheque stub book and cancelled checks. This is particularly true of voluntary non-mercantile bankruptcies—but also occurs in mercantile cases."[3] Although this condition may exist to some extent today, it is by no means common, and even though the accountant may have difficulty in finding the books, they are usually around somewhere.

It is interesting to note in this connection that Section 14 of the Chandler Act provides that the bankrupt shall be denied a discharge, not only where he fails to keep books or records but also where he fails to preserve them so that his business transactions and financial condition may be ascertained. This change in the law is intended to meet the defense of bankrupts, often made, that missing books or records have been destroyed because they were no longer in current use.[4]

A special attempt should be made to obtain the minute book of the debtor, if a corporation, because here can usually be found important discussions which will affect the auditor's report, such as authorization of dividends, authorization of officers' salaries, valuation of assets, etc.

Obtaining a Trial Balance and Supporting Schedules

The auditor will often find that the books of the organization are not

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[1] Goldman, D., "The Accountant in Bankruptcy and Receivership Cases," Accounting Review, September, 1933, p. 222.

[2] Fitzpatrick, Paul, "The Problem of Business Failures," 1936, pp. 51-2.
Hussey, A. V., "Some Interesting Points in Insolvency Practice," Accountant (London), Vol. 94, June 13, 1936, p. 889.
McKinsey, J. O. & Noble, "Accounting Principles," p. 859.
Taylor & Miller, "Intermediate Accounting," Second Edition, 1938, p. 461.

[3] "Accountants & Bankruptcy Examinations" American Institute of Accountants Bulletin, No. 104, December 15, 1932, p. 265.

[4] Goldman, D., "The Accountant in Bankruptcy and Receivership Cases," Accounting Review, Vol. 8, No. 3, September, 1933, p. 221.
Weinstein, J. I., "Certain Phases of the Chandler Bill Which Are of Particular Interest to Accountants," New York Certified Public Accountant, January, 1939, p. 186.

written up to date . No significance may attach to this, unless the work is very far behind, because it occasionally happens even with solvent firms. The office staff of the debtor should therefore be instructed to bring the books up to date at once. If no member of the debtor's staff is available, the auditor should bring the accounts up to date himself on his working papers. It is important for the accountant in this type of investigation to realize that he is to make no mark or notation whatsoever on the books or records of the debtor organization. When all entries have been posted to date, the accountant will take off a trial balance of the general ledger.

Schedules of the receivables and payables are prepared from the subsidiary ledgers. The accounts receivable schedule should be aged so that the auditor can estimate the realizable value of the customers' accounts. The schedule of creditors should list their addresses in order that they can all be notified of the proceedings.

To determine whether any unpaid bills have not as yet been entered in the purchase book, the unpaid bill file should be examined for such invoices. The receiving record should also be inspected to ascertain whether any merchandise was received recently, for which there are no invoices on hand.

If the debtor lets out work to contractors, a schedule of the amounts due them should be drawn up. On such schedule there should also be entered the materials at each contractor, the money owing to him, as well as the additional amount required to be expended for trimmings, supplies, etc., to complete the merchandise. Such a schedule will give the creditors a basis for deciding whether it is advisable to pay the contractors the amounts due them, and take in for sale the merchandise that they are holding, or else to allow the contractors to sell the merchandise for whatever they can get, and then become general creditors for any balance still due them.

In order to obtain a more exact check on the receivables and payables outside confirmation is, of course, desirable. However, the auditor is often required to have his report ready in such a short time after the start of the investigation that independent verification would be difficult.

Inventory

An inventory of all merchandise (including supplies) should be taken either by the debtor's employees under the accountant's supervision, by the accountant himself, or by a representative of the creditors. If perpetual inventory records are kept, they should be compared with the physical inventory as taken, and an attempt should be made to reconcile any discrepancies. If there is any merchandise at branch offices, warehouses or factories, it should be included, with a notation of where the stock is held.

Accruals, Adjustments and Statements

All accruals for unpaid labor, expenses, taxes, etc. up to the date of the audit should be made on the accountant's working papers. The usual adjustments such as setting up reserves for depreciation, bad debts, cash discounts, etc. should be made. This information can usually be obtained by reference to previous years, or from discussion with the office staff.

The auditor's statements will include:

1. A Balance Sheet as of the date of the audit, and as though the business were continuing as a going concern.

2. A Statement of Income and Profit & Loss from the date of the last financial statement issued to creditors or from the date of the

last closing of the books to the date of the audit. This statement should show the percentage of each item to the net sales.

3. A Statement of Affairs and Deficiency Account as of the date of the audit.

The Cause of the Financial Difficulty

With the statements as a basis, the auditor will try to determine the cause of the debtor's financial difficulty. If the debtor has been unable to meet maturing obligations because of the lack of quick assets, the balance sheet will usually be the object of further study. It may be found that the investment in fixed assets is very heavy. In such a case it might be advisable to prepare a statement of application of funds to show how the profits and liquid assets of the business were used.

More frequently the firm in financial difficulty is "insolvent" in the narrower sense—that is, there are more liabilities than assets. In such cases the investigator is more interested in the income statement. Here he will attempt to find the cause of the poor showing. An organization may have issued a financial statement only a year or even less than a year previously, showing a fair-sized capital and surplus, and possibly a profit for the preceding fiscal period. Why did the picture change so suddenly, and the loss occur in the present period?

The auditor should compare the percentages of the gross profit on sales, selling and administrative expenses with the percentage usual for that industry and note any differences. He may find that instead of a gross profit of 40% common in such a business, the actual percentage was 10% or 5%, or there may even have been a gross loss.

The insolvent organization usually has not kept accurate cost records and therefore may either be paying too much for its merchandise, or selling it at too low a cost to make a satisfactory profit. It may also be found that the business has been selling its goods, usually in job lots, for less than the market price in order to obtain ready cash to meet its maturing obligations. A month to month analysis should be prepared of the sales made below the market price and an average selling price per month obtained.

The purpose of such an analysis is to determine (1) whether these off-market selling prices were the major cause of the loss, and (2) to establish the basis for a turnover proceeding in bankruptcy. As will be explained later, under the Chandler Act (Section 14) it is presumed that the merchandise was sold at least at cost or more than cost, unless cost records are kept by the bankrupt. This analysis will help to determine whether such was the case or not. It should also be kept in mind that these job sales below cost may have been made for the purpose of defrauding creditors. They may have been made to a relative or friend of the debtor who will later share the profit on the resale of this merchandise with the debtor.[5]

Expenses

If the gross profit percentage is near the norm for the particular industry, then the auditor will turn his attention to the selling and administrative expenses to see if they are abnormal. Sales commissions may not be producing results commensurate with the outlay. Traveling expenses and proprietor's salary and drawing accounts should be analyzed to determine whether they are being used to fraudulently take funds from the business.

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[5] Weinstein, J. I., "Certain Phases of the Chandler Bill Which Are of Particular Interest to Accountants," N. Y. Certified Public Accountant, January, 1939, p. 186.

In addition to the study of the statements as a possible cause of failure, the auditor should go into the history of the business to obtain clues. He may find that there is a "defective corporate organization wherein stockholders are still liable on their unpaid capital stock subscriptions or that directors, dishonestly or otherwise, abused their discretionary powers by placing unjustifiable values on the property paid in or on services performed as the basis for the issuance of capital stock." [6] Bonds may have been issued based on invalid or insufficient consideration.

The results of this study will give the creditors a basis for determining the future course of the business. If the cause of the difficulty seems to be too great a proportion of fixed assets, they may grant the debtor an extension, and have him try to arrange to get some additional capital into the business. Another remedy might be to convert some of the fixed assets into more liquid ones.

If the investigation shows that the costs are abnormally high, and that, apparently due to competition, the business cannot secure an adequate sales price for its merchandise to cover costs and give it a fair profit, the creditors may decide that the business should be liquidated.

Was the Last Financial Statement Issued to the Trade a Fraudulent One?

Most business organizations present to their prospective suppliers of merchandise some sort of a financial statement to be used as a basis for the granting of credit. The statements vary from a simple one of assets and liabilities to detailed balance sheets and income statements, such as those requested by the credit associations, credit agencies and banks.

The Balance Sheet

If such statements were issued to the creditors by the insolvent business organization, the auditor should obtain a copy of the latest one issued. He should then take off from the general ledger a trial balance as of the date of the statement to see if the figures there agree with those on the debtor's books subject, of course, to adjustments that may have been made for the statements. Each asset on the balance sheet should then be verified, if possible, as to its existence, value and ownership at the statement date. The debtor's reconciliation of the bank statement should be checked by the auditor. He should also verify the bank balance directly with the bank, as well as find out from them whether the debtor is primarily or contingently liable on any loans or notes.

Receivables

A schedule of accounts receivable should be prepared from the subsidiary ledger and its total checked with the control account in the general ledger. Subsequent payments on these outstanding amounts should then be traced and any write-offs investigated. It may be found that many old accounts, which were bad debts on the statement date, have been included in the accounts receivable as current assets. The failure to charge off these bad debts, while not conservative accounting practice, would not be proof of fraud. However, such a failure might tend to show an attempt by the debtor to deceive his creditors by making the financial condition appear better

[6] Goldman, David, "The Accountant in Bankruptcy and Receivership Cases," Accounting Review, Vol. 8, No. 3, September, 1933, p. 221.

than it actually was. Such action would probably influence the creditors in their decision as to the future of the business.

The "Loans Receivable" account should be scrutinized to see if the loans outstanding on the statement date were paid in the succeeding period. It occasionally happens that so called "Loans Receivable" included in current assets are permanent advances which will never be collected and which should have been written off to profit and loss or surplus. The same comment applies to the "Advances to Salesmen" account, which may contain overdrawings by salesmen which will never be paid back.

Inventory

The inventory is often the largest asset and therefore one of the most important items on the balance sheet. It is usually one of the most difficult to verify. If a copy of the inventory taken on the statement date is available, or if a perpetual inventory record is kept, the problem is much simplified. The subsequent use of the raw material or goods in process, or the sale of the finished goods, can usually be traced in the next accounting period.

If there are no physical or perpetual inventory records, the value of the inventory as of the statement date must be obtained by working backwards from the present inventory. To the value of the latter we add the cost of merchandise sold during the period, and from this sum we subtract the cost of purchases, or manufacturing costs (material, labor and overhead) for the period, to get the inventory at the beginning of the period. If accurate cost records are kept it will be easy to determine the cost of goods sold during the period. If there are no such records, an average cost price for each type of merchandise sold must be calculated. This average cost price multiplied by the number of units sold will give the total cost price.

The pricing of the inventory can usually be checked to the invoices or to market quotations on the statement date. Although it is conservative accounting practice to value the inventory at the lower of cost or market, the auditor may find that the debtor's inventory was valued at cost alone or market alone. If the statement issued to the trade specifically mentions the method of pricing, and another method of pricing is used, then the statement is a false one. If, however, the method of pricing is not mentioned, it would be difficult to prove such a statement a fraudulent one because of inventory valuation, although it may be indicative of an attempt to deceive the creditors.

If the inventory value as obtained by one of the above methods does not agree with the figure shown in the statement issued, there are several possible explanations. One is that the average cost figures used above are not accurate and the actual cost varied somewhat from the average cost. This will usually satisfactorily explain a small difference in the figures, but a large difference should be further investigated by the auditor. Suggestions as to such procedure are given hereafter.

Fixed Assets

The fixed assets should be examined to see whether they are valued at cost. Oftimes an appraisal is made of the fixed assets, and any increase in value shown by such appraisal charged to the asset on the books with a credit to surplus. This increased value may be the figure used on the Balance Sheet. Such a practice, like those mentioned above, while not in itself fraudulent, may tend to show an attempt on the part of the debtor to mislead his creditors.

It is important for the auditor to determine whether all the assets as

listed are now in use, and whether some may not have been scrapped or sold. The auditor should also convince himself as to the ownership of the fixed assets. He may find, for example, listed as fixed assets automobiles, whose cost should have been charged off to traveling expense. Some businesses make payments on the cars of their salesmen, and deduct these payments from the commissions they earn. When the car is fully paid for, it belongs to the salesman but the concern might have carried the payments as a fixed asset on the books.

The depreciation reserve should also be investigated by the auditor to determine whether it is adequate to take care of the wear and tear on the fixed assets. It may be found that little or no depreciation was taken in the recent accounting periods and so the fixed assets may be overstated on the statement.

Investments and Other Assets

According to accepted accounting practice, investments should generally be valued at cost. However, if the market or book value of the investment decreased greatly below cost, then the investment should be written down to a nominal figure or to its market value. If this is not done, the asset may be overvalued on the statement. The auditor should try to determine the book or market value of all investments at the date of the statement and see how much they differ from the values listed on the Balance Sheet.

Among the other assets on the statement are often listed security deposits. The auditor should determine from the one who holds the "security" whether it is still being held as such and whether it will be returned at the expiration of a certain period of time or when the debtor pays all he owes to this creditor. It may have previously been applied by the holder of the security against a debt owing to him and so should have been written off by the debtor.

Liabilities

The liabilities, actual or contingent, are not easy items to verify. The auditor could send out a request for verification to the creditors listed in the ledger, although the percentage of replies would probably be small because the creditors may not bother to go back in their ledgers a long period of time to determine the amount that was then owing to them. Moreover, there may have been liabilities to creditors who do not appear in the ledger and so these creditors would not receive verification notices.

Therefore, the auditor should first take off a schedule of the accounts payable ledger as of the statement date to see if it agrees with the control. He should then go through the invoices entered in the first month or two of the subsequent accounting period and see if they are dated before the date of the statement. This procedure will often disclose that a large quantity of merchandise was received before the statement date and taken into the inventory, but not entered on the books until after the statement date. By a check of the receiving record the auditor can usually tell when the merchandise came in, and whether it was included in the inventory.

The checks paid in the subsequent period should be examined to see whether payment was made on a liability that existed on the statement date but was not recorded on the books. For example, a check may repay a loan made to the debtor organization before the statement date but not recorded on the books, or all of the expenses of the prior period may not have been accrued, and so the check may be paying for such an expense.

When fixed assets are purchased, and only partly paid for, the customary procedure is to place the

asset on the books at its cost value and set up the liability still due thereon. However, the auditor may find that fixed assets were purchased by the debtor before the statement date, but the fixed asset account was only charged with the amount of cash paid up to that date. The effect of this practice is to understate the current liabilities, overstate the net working capital and thus show a more favorable current position than actually exists.

Contingent Liabilities

It is not easy for the auditor to determine what the contingent liabilities were on the statement date. However, by examining cash disbursements in the current period he may find that payments were made in settlement of lawsuits, for notes which had been endorsed by the debtor and not met by the maker, additional tax assessments or other forms of contingent liabilities for which some provision should have been made, or at least their existence mentioned on the statement. For example, much of the loss of the current period may have been caused by the fulfillment of substantial purchase commitments made at a time when prices were high. The market may have declined since then, and the debtor may have had to sell his merchandise at a loss because of the lower price. Such purchase commitments should have been mentioned in the statement issued to the trade.

Hypothecated Assets

Some of the assets appearing on the statement may not actually belong to the business itself, but may have been hypothecated to creditors as security. For example, accounts receivable are often pledged as security for loans by factors or other finance agencies. On the other hand, the fixed assets may be mortgaged, although no such liability appears on the balance sheet. By going through the checks paid in the current period, the auditor will note payments to the factor, or interest payments on the mortgage which should lead him to the discovery of the pledging of the assets.

Profit and Loss Statement

In order to "dress up" the statement by improving the current position, as well as the operations for the period, a business will sometimes put through a series of fictitious charges during the last few days of the accounting period. During the first few days of the next period, credits are issued to apply against these charges. By going through the credits issued at the beginning of the period, the auditor can see if any of them apply to charges made at the end of the preceding period. If the amounts of the credits are large, the auditor should communicate directly with the customer to see whether he had actually ordered the merchandise and then cancelled his order, or whether the charges were fictitious.

Another method that some businesses use to obtain the same result is the issuance of "exchange" checks. During the last few days of the period, the business receives large amounts in checks which it credits to sales. The cash position is thus improved and the sales increased. In the next period checks are issued by the business to those persons who gave the original checks, and the amount thereof is debited to "Purchases." By looking for such entries, the auditor can often discover this procedure.

Subsequent Trial Balances

Creditors occasionally call the debtor's accountant in the interim between published statements to inquire as to whether there has been any change in the debtor's condition since the statement date. The accountant will often give the creditors figures from the monthly trial

balances. The auditor should endeavor to learn whether any such figures were given to creditors, and then by examining the ledger of the debtor, see whether the figures as given to the creditors were correct.

The above suggested procedures should determine whether the debtor attempted to obtain credit under false pretenses. However, to prove in a court of law that the statement was truly fraudulent is a difficult matter. As Fixel shows in his treatise on false financial statements, the legal elements of fraud must all be present. The representations made to the creditors must be representations of fact, the fact must be a material one, and fraudulent intent must be proved.[7] While fraud is thus difficult to prove legally, the auditor, by showing that the debtor's practices all point to an atempt to deceive the creditors, will probably influence the creditors' decision as to the future of the business.

Was There Any Fraudulent Withdrawal of Assets or Fraudulent Preference of Creditors?

Withdrawal of Assets

Merchandise is one of the assets often taken from the business in an attempt to defraud creditors. When the debtor sees that his business is doing poorly and that he will soon have to close, he often arranges to have some of the merchandise on hand taken away to the business of a friend or relative, or to a warehouse. Here it will either be sold or kept for a few months until the business has closed. Then the debtor will go back into business under another name and with this stock.

As was mentioned in the last section, the auditor should work back from the present inventory to that of the previous statement date. If he does not arrive at substantially the same figure as that in the statement, there may have been a false inventory at the beginning or a fraudulent withdrawal since the statement date.[8]

"Turnover" Proceedings

If there seems to be a fraudulent withdrawal of assets, "turnover" proceedings may be instituted against the debtor. However, a fraudulent bankrupt has frequently succeeded in defeating a "turnover" proceeding by a blanket statement that his sales were made below cost and by the defense that he could not determine the cost of the closing inventory, because at the time of the initiation of the "turnover" proceeding, the property had actually been liquidated and therefore could not be physically examined.

The Chandler Act has made two important changes in this procedure, lifting from the trustee the unrealistic burden of proof and properly imposing the burden of proof, as far as it can be done, upon the bankrupt. By Section 7 it is now provided that the bankrupt may be required by the Court, while the closing inventory is still on hand, to prepare and file with the Court a detailed statement of its cost. By Section 21 it is further provided that, unless the books and records of the bankrupt disclose cost, it shall be presumed that the sales during the accounting period were made at not less than cost to the bankrupt. However, this presumption may be rebutted by the

[7] Fixel, Arthur E., "False Financial Statement," 1924. Chapter I.

[8] Olney, Peter B., "The Accountant's Role as a Fact Finder and a Witness"—Proceedings of Round Table Forum, Technical Committee on Bankruptcy Procedure, New York State Society of Certified Public Accountants, October 30, 1940.

bankrupt with proper proof, but he will no longer escape with the blanket explanation that he sold his merchandise below cost.

This rebuttable presumption is fair to the bankrupt in that it gives him every benefit of a reasonable doubt. It is proper to start with the assumption that even an embarrassed debtor does not normally sell his merchandise below its actual cost to him. Upon the dishonest bankrupt it places the burden of a choice between a turnover order for the shortage which the accountant may disclose or a frank and full disclosure of his property. Where he has made large sales in bulk and out of the usual course of business, he will now be under pressure to disclose all of the facts and the circumstances with regard thereto. Thus it is expected that collusive arrangements between a bankrupt and a "fence" will involve considerable risk both to the bankrupt and the "fence," and should be considerably less frequent."[9]

The auditor will also examine the checks issued during the current period, paying particular attention to those made payable to "Cash," "Expense," "Traveling Expense," "Payroll," "Petty Cash" or the owners of the business. He should try to find a reasonable explanation for all such checks, watching for excessive withdrawals. In going through the checks he should be on the lookout for alleged creditors to whom money was paid, although no merchandise or service was received by the business. Where checks were paid to creditors in large amounts or at frequent intervals, the auditor should examine the paid bill file to support such disbursements.

An analysis should be made of all owners' drawings, salary, traveling and entertaining accounts so as to give the creditors a picture of what was actually drawn from the business. The auditor should also determine whether any close relatives are on the payroll, and if so, if they are drawing excessive salaries. An otherwise successful business can be ruined by the owner and his family drawing out an excessive amount of cash. If such has happened, an additional permanent investment in the business might set it on its feet again.

Preference of Creditors

The schedule of accounts payable should be aged as of the due date to see whether certain of the accounts are long past due while others are not yet due. The checks issued during the last few months should also be carefully studied so as to determine whether any were given to creditors other than those entered in the accounts payable ledger. The auditor should also try to determine whether any family relationship existed between the debtor and any of his creditors, as family creditors may have been preferred over the others.

If any preferences were given, the auditor should state them in his report, so that the creditors can consider this in determining the good faith of the debtor, as well as a basis for bankruptcy proceedings if that course is decided on.

What Shall the Report to Be Presented to the Creditors Contain?

The report usually opens with the scope and purpose of the examination conducted by the auditor. A brief resumé of the history of the organization, officers, and type of business is usually helpful to the creditors.

Balance Sheet

The report should then discuss the present financial condition of the business as illustrated by the balance sheet. A comment should be made about each account thereon, stating

[9] Weinstein, J. I., "Certain Phases of the Chandler Bill Which Are of Particular Interest to Accountants," New York Certified Public Accountants, January 1939, p. 188.

the extent of verification, if any. The basis of the valuation of the assets should also be stated. Schedules should support the accounts receivable, accounts payable and contractors payable accounts. It is also wise to include a schedule of the doubtful or bad accounts which were written off. In discussing the inventory, the basis of pricing should be stated. If there were any merchandise at the contractors, the auditor should mention in his report how much it will cost to finish the merchandise.

Profit and Loss Statement

The elements of the profit and loss statement should be analyzed by percentages so that the creditors can more easily compare them with those of other businesses in the same field. The auditor will also try to explain the reason for the loss if there was one.

Montgomery says that an operating statement is not usually made a part of the report presented to the creditors.[10] However, it seems to the writer that this particular statement is of extreme importance to the creditors because it usually discloses the cause of the financial difficulty and thus gives them a basis for judging whether the debtor can operate on a profitable basis in the future, if he is allowed to continue in business. The profit and loss statement may also give the auditor a clue as to fraud in connection with the insolvency. In connection with the reorganization of a bankruptcy, W. Randolph Montgomery states, "Upon a correct and expert analysis of the corporation's operating statements depends the feasibility of successful reorganization. Proof of feasibility is an important prerequisite to confirmation (of the reorganization plan)."[11]

Statement of Affairs and Deficiency Account

As was mentioned earlier in this paper, a statement of affairs should also be included in the report so that the creditors can get an idea for themselves as to approximately how much they could realize on their claims.

In preparing a statement of affairs the auditor should recognize the legal relationship, if any, between the individual or individuals comprising the insolvent business and its creditors. In the case of a sole proprietorship, all of the assets owned by the proprietor, whether a part of the business or not, and all of his liabilities, whether business or personal, must be included. All personal and business creditors share in the assets on the same basis.

In preparing this statement for a partnership, the assets comprising the personal estates of the respective partners must appear, subject to the "Rules of Marshalling." Thus the assets of the individual partners should be set off by their liabilities and any balance appear for the benefit of the partnership. In a corporation, on the other hand, there is the legal separation between the company and its stockholders, so that only the assets and liabilities of the corporation itself are shown. In general, the creditors of a corporation have no claim against the stockholders of the company. This is subject to the statutory liabilities of stockholders as defined by the laws of the various states.[12]

In spite of the seeming importance of the statement of affairs in the report to creditors, many auditors do not make one. Their attitude is that the creditors themselves should decide what the assets are worth on on the basis of the facts presented by the auditor. Although it is true

[10] Montgomery, R. H., "Auditing Theory and Practice," Fifth Edition, 1934, p. 638.
[11] Montgomery, W. R., "Section 77-B of the Federal Bankruptcy Act," New York Certified Public Accountant, January, 1936, p. 11.
[12] Mannix, "Accounting for Corporations," 1937, p. 229.

that this statement is probably more one of opinion than other types of financial statement, it seems that the auditor from his wide experience should be in a better position to determine the realizable value of the assets than the creditors themselves.

The auditor may have a tendency to be over-optimistic in his statement of affairs. Clark states, "I have rarely known such a statement which did not make out the debtor's position better than it really was. This suggests that optimism, either on the part of the accountant or the debtor must be tempered by the honest desire to avoid misleading the creditor."[13] The debtor will perhaps produce a valuation of the property prepared for his bankers or otherwise. Such a valuation should be accepted with the greatest reserve for the purpose of a statement and inquiry may show that all efforts on the part of the debtor to sell the property at a figure at or even below the valuation have not produced an offer at all.

The deficiency account calls for the greatest care on the part of the auditor. It is here that the creditors expect to find in a simple form some reasonable explanation, so far as figures are concerned, of the debtor's existing deficiency. The loss due to operations should be clearly differentiated from loss on liquidation of assets. Occasionally this information is rendered in the form of a statement which may set forth a little more clearly what has happened. At times it is desirable to expand the form of statement of affairs to provide therein information concerning the estimated shrinkage in value of the various assets, rather than in a separate deficiency statement.

Recommendation to the Creditors as to Ultimate Disposal of the Business

Many auditors do not include in their report any recommendation to the creditors as to what their future action in connection with the business should be. It seems to the writer that such an attitude is evading one's responsibility and shows an unwillingness on the part of the accountant to assume any responsibility for his opinions in this connection. The auditor, because he himself has worked on the books and records of the debtor, and because he usually has had experience with similar cases, should be in a position to advise creditors. They can either follow his suggestions or adopt a plan of their own, but at least they have the auditor's opinion based on his experience.

The creditors can take one of two courses of action. If the financial condition of the debtor is not serious and a remedy seems possible of attainment, they should undertake to rehabilitate or adjust his affairs. If the creditors believe, however, that the debtor's condition is serious, they may decide on partial or total liquidation.

"Where the concern has previously been in difficulty, the record thereof may prove very enlightening. The fact that assets were substantial in relation to liabilities shows that the debtor did his best to conserve the assets for the creditors instead of diverting them. The existence of family creditors, or the purchase of the business by the family, in the bankruptcy court is an unfavorable sign."[14] Earlier in this article were mentioned other ways of telling whether or not a debtor acted in good faith. On the basis of these findings, the auditor will present his suggestions to the creditors.

[13] Clark, S. O., "Some Notes on Bankruptcy Practice," Incorporated Accountants Journal (London) July, 1936, p. 350.
[14] Steiner, W. H. "Mercantile Credit," 1937.

COMMITTEE ACTIVITIES

Inventory and Other Year-End Tax Problems

By THE COMMITTEE ON FEDERAL TAXATION

On December 15, 1941, at the Engineering Auditorium, the Committee on Federal Taxation inaugurated the first of its monthly meetings designed for the purpose of enabling the membership of the Society to more fully participate in a discussion of federal tax problems.

The general statement and discussion of the subject was prepared and presented by Mr. Nathaniel B. Bergman. Questions, and answers and comments by members of the committee, have been interpolated in the relevant sections of the paper.

This article and discussion must be regarded as expressions of personal opinion by the committee members, and not an official statement of the Society or of the Committee on Federal Taxation.

Inventories

Inventories are required in every case in which the production, purchase or sale of merchandise is an income-producing factor. The bases established over many years for valuing inventories have now been supplemented by a method referred to as the last-in, first-out method; almost affectionately alluded to as LIFO. However we still have the vast majority of taxpayers who value on the basis of *cost* or *cost-or-market-whichever-is-lower* with numerous problems thereunder.

The war will create a number of interesting questions. Already there are instances of goods paid for but still in enemy countries. What value, if any, should be placed on such goods?

Question: A domestic corporation is owned by a foreign national who has been classified as an alien enemy. Consequently the domestic corporation has been taken over by the U. S. authorities. At the present time there is merchandise in transit from this foreign country. The domestic corporation has received notice that the merchandise has been charged to their account and title has passed. Undoubtedly this merchandise will never be received by the end of the year. How should it be valued for tax purposes?

Answer: I don't think it should be included in inventory but should be set up as a separate item such as merchandise in transit. On the theory that a deduction should be taken in the first year in which the trouble arises, I would be inclined to claim the item as a loss.

Question: How about a friendly country such as the Philippine Islands where we have a plant and inventories of a perishable nature and subject to style changes. What will be our tax situation as we cannot possibly receive any information before the end of the year?

Answer: I think it is one of numerous cases this year where it seems sensible to claim the loss but it seems doubtful the Treasury will allow it. You can always refer to the U. S. Supreme Court's decision in S. S. White Dental Manufacturing Co. in which the court stated "The Taxing Act does not require the taxpayer to be an incorrigible optimist."

Under ordinary circumstances and for normal goods, market means current bid price prevailing at the date of the inventory. It does not apply to goods for delivery on a contract at a fixed price; such goods must be inventoried at cost unless the contract is subject to cancellation by either party.

Cost under the regulations does not differ fundamentally from the accountant's concept, except that cost of goods which are still on hand from the beginning of the year would not ordinarily be considered by him to be the previous inventory value. Regulations 103 make allowance for determining costs in special situations.

Goods which are not saleable at normal prices or goods which cannot be used should be valued at selling prices less cost of disposition.

Retail merchants are permitted to use the so-called "retail method" the effect of which is to value at cost or approximate cost. One advantage of this method is that the physical work of valuing a tremendous number of items separately is obviated. The method would be a true cost or market method if the reserves required to be set up in the balance sheet at the close of each year for depreciated goods were deductible. In order to be allowed such deduction, the Treasury requires that the depreciated goods be actually offered for sale at reduced prices.

Serious consideration must be given to

items which are likely to be affected unfavorably by the emergency restrictions. A reserve for depreciation is not allowed unless it can be shown that if due consideration had been given to known conditions, the inventory value would require a reduction in the amount of the reserve. Goods of no value should not be omitted from the physical inventory; they should be included but valued at zero. This is a year in which certainly the combined judgment of the taxpayer and his accountant will be severely tested in respect of valuations. Quantities of repair and maintenance materials on hand may be high: they are subject to the same rules for valuation as the goods on hand for sale.

The fundamental principles of the life method are (1) there is a minimum inventory in every business which partakes of the character of permanent investment and (2) the goods sold have to be replaced at current price levels. Producers and processors of certain non-ferrous metals and tanners were given the right under the 1938 Act to adopt the last-in, first-out method of valuing inventory. For 1939 and subsequent years the privilege of using this method was extended to all who use inventories.

Taxpayers should adopt the method if they believe in it as sound business policy. If the method is adopted solely as a tax-saving device, there may be serious disappointments. As a business policy, however, the method prevents a showing of large profits when prices are rising since sales at high prices would not be made with low priced goods. Under the first-in, first-out method profit on goods may not all be realized and available for distribution since profit must be reinvested in a stock of goods no larger than what could have been acquired earlier for less. As the price level rises, the hazard on the elective method would seem to be less. When prices drop, a loss occurs in inventory on cost or market basis.

If inventories are large in relation to other assets lifo minimizes extremes of profits and losses. In theory it would seem that when prices are rising the profits would be less on the lifo method than on the first-in, first-out method. In a falling market losses should not in theory be so great since cost would still govern valuation and act as a balancing factor if inventory remained at a higher price level than the current prices for costing sales.

Application to use the elective method must be made on form 970 and be filed with the return. This form contains instructions in detail. Considerable time may elapse before the Commissioner takes action. Approval of the plan requires that the opening inventory be valued at cost and payment of additional tax arising therefrom for the previous year if any is due. Regulations 103 states that taxpayer must agree to any adjustment which may be made in the inventories of *prior taxable years;* this is somewhat vague but it probably has reference to the inventory of the previous year.

The important thing to decide is, which items should be selected and if certain articles are selected, should raw materials only be selected in order to minimize computation and identification. In many businesses it might be feasible to include the entire inventory.

Increases in inventory at close of the year must be valued at latest costs, earliest costs, or average costs, whichever the taxpayer elects, or any other method which in the opinion of the Commissioner clearly reflects income. The Code requires that for the year for which the elective method is used, all financial statements shall have reflected the inventory on the elective method. If market was used, however, in such statements and reports, this will not operate to deny the right to use the elective method.

Is it necessary that an article on hand at the close of the year be identical with an article on hand at the beginning. In the case of raw material this may not be difficult in some cases. In the case of finished goods, however, where styles, grades, etc., are factors, how far will taxpayers have to go? Suppose a shirt manufacturer had at the beginning of a year 10,000 white shirts, size 15, and at the end of the year he had 2,500 white shirts size 15 and 8,500 shirts size 15½ of the same material but with a stripe. A literal interpretation would require 7,500 shirts of the opening inventory to be consumed and valuation of the 8,500 shirts on one of the three bases as an addition.

In this example, I think the taxpayer should be allowed to use yardage as the basis. If cotton as well as other commodities are used, the yardage of each should be separate. In the case of a steel company, the basis should be steel, regardless of the shape in which such steel appears at the end of a year.

Question also arises as to whether or not where lifo is used and during the year an improvement is made in the product, can the improved product at the end of the year be taken as the equivalent of the product at the beginning of the year? It depends on the extent of the improvement. If the improvement has the effect of resulting in a radically different product, different price and different marketing, the answer is no. If the improvement is merely an incident that does not affect

the various factors mentioned, the answer is yes.

The fact is that the last-in, first-out method permitted under the 1939 tax law has been adopted by a relatively few companies prior to 1941 and the Bureau of Internal Revenue has not passed upon many cases, if any. Regulations issued under the law are exceedingly broad and it remains to be seen how the Bureau interprets them. If there appears to be a lack of positiveness about this subject it is because the whole thing is in an extremely embryonic stage. At the present it is necessary to use as a guiding principle what seems most reasonable under the circumstances.

In view of all of these factors, there are at least two questions to be seriously considered (1) whether the plan should be adopted and (2) whether the auditor should set up a tax reserve until the plan has been formally approved. In any event, the question as to what are identical goods on hand at the end of the year must be decided before the auditor can rest easy in so far as his balance sheet is concerned. If the principle of the minimum inventory is basic to lifo, then *any* goods of an aggregate value of the opening inventory should perhaps be the constant.

Question: Under the last-in, first-out method can a loss be taken for obsolete merchandise or must it be taken at cost?

Answer: There is involved here a conflict of two principles. The inventory principle requires the inclusion at cost until the merchandise is disposed of. Market value write-downs are not permitted. On the other hand deductions are allowed for losses sustained, and when merchandise becomes obsolete there is a sustained loss. I believe that the latter principle would control and the deduction be allowed.

Question: On the last-in, first-out method if there are three grades of merchandise, but, at the beginning of the year in which the method is first used, there are only two grades in the inventory and at the end of the year there are the three grades, must the grade that was not in the inventory at the beginning of the year be taken at the cost of acquisition during the year or can it be figured on the basis of the relative valuation it would have had if in the inventory at the beginning of the year?

Answer: It all depends upon what is the common denominator for inventory. If we assume that lumber is involved and all grades of the species are integrated into one price based on relative value of the different grades, then interpolation of the price for the missing grade is permitted. If, however, classification is made on the basis of each grade and quantities at the beginning, and the end of the year compared by grade, then the presence of the new grade carries the price of the cost of acquisition during the year.

Question: In adopting the lifo method, is it permissible to use cost or market at the year-end?

Answer: You can value inventories at market without losing the right to use the lifo method for financial purposes but for tax purposes cost must be used.

Establishing Losses

In view of the high normal and surtax rates, taxpayers will wish to establish losses on securities and on any other assets if not in conflict with the company's policy. The possible effect of a change which might be made in new legislation limiting deductions of long-term losses should not be overlooked. If there appears to be a short-term net capital loss which is not deductible, under the present law sales could be made of securities which would result in short-term capital gains to offset the short-term losses. In this connection it should be borne in mind that wash sales at a gain are recognized and such gains may be used to offset losses. Federal and state government obligations issued on or after March 1, 1941 on a discount basis are not capital assets under the present law.

It may be possible to demolish some buildings and take a loss, provided that new buildings are not erected in their place.

The point is, taxes are high and deferring deductions is of questionable advantage. It is a safe policy always to deduct losses in the earliest possible year. In the case of worthless bonds, they must be charged off within the taxable year as well as ascertained to be worthless. If the charge-off is made shortly after the end of the year but before the books are closed, this has been held to comply with the requirement.

Question: Suppose I make a gift to a charitable organization of 100 shares of stock which cost me $1,000, but which had a market value of $5,000 at the time of the gift. Do I have to report a gain of $4,000 for federal income tax purposes?

Answer: The answer depends on whether you originally made a pledge

of $5,000 to the charitable organization, or whether you merely pledged 100 shares of this particular stock. In the former instance, you would have to report a taxable gain of $4,000 since the liquidation of a dollar liability is a taxable conversion of the property. If, however, you merely pledged 100 shares without mentioning market value, this will not be considered a sale or exchange and there will be no taxable gain reportable.

Question: Corporation A owns securities of another corporation for which its tax basis is $100,000, but which are worth $25,000. The corporation wishes to distribute these securities to its shareholders as a dividend. How can this best be done, assuming that Sec. 24(b), I.R.C., does not prevent a loss allowance for tax purposes on a sale of assets by Corporation A to its stockholders?

Answer: If Corporation A distributes the securities as a dividend in kind, no gain or loss for tax purposes will be recognized to the corporation from such disposition.

If Corporation A declares an ordinary dividend of $25,000 and satisfies the resulting liability by distributing the securities for which its tax basis is $100,000, a capital loss of $75,000 will be recognized for tax purposes.

Question: Two domestic corporations are controlled by the same individual stockholder but neither is a personal holding corporation. One corporation sells securities at a fair price to the other and sustains a loss. Is this loss deductible?

Answer: The loss is deductible. The limitations contained in Section 24(b) (1) of the Internal Revenue Code would not apply to these facts.

Accruals

It may seem elementary to touch on accruals, but by this term is meant virtually all liabilities for expenses incurred and for amounts which may have to be paid due to pending claims, etc. against the company. There is one piece of advice which can generally be safely followed with respect to claiming deductions, "Do it now!"

It does seem as though the Board has denied most reserves which prudent businessmen consider it necessary to provide, but tax history is in the making and so long as claims for refund are merely an incitement to the Bureau to find offsets, the taxpayer should act on the guiding principle of all living creatures, self-preservation.

Among accruals, should be included all excise taxes which are imposed on the corporation.

This might be a good year for making a more careful scrutiny of the various state and city taxes to ensure setting up any special levies.

Corporations paying all or part of expenses of subsidiaries having taxable net income should take steps to charge such subsidiaries with their proper share of such expenses. This will increase the taxable income in the lower tax brackets and will reduce the danger of disallowance of excess expenses to the parent corporation.

It is important to inquire into law suits. If no appeal is going to be made, a liability should be set up.

Question: Assume that a taxpayer on the accrual basis owns bonds of a company which appears in such bad financial straits that there seems little likelihood of collecting any interest. Should the interest be accrued?

Answer: In accordance with the case of North American Oil Consolidated v. Burnet, the accrued interest should not be reported for tax purposes unless there is reasonable assurance that the accrued income will be collected. It may, however, be advisable to make a disclosure of the facts in appropriate cases.

Question: When should the tax on declared value capital stock imposed by the Federal Government be accrued?

Answer: The capital stock tax is imposed on the carrying on of business at any time during the period July 1 to June 30, although it is not payable until one month after the close of the period. The entire amount of the tax accrues on July 1.

The question of time for deduction of the $.15 additional capital stock tax imposed by the Revenue Act of 1941 is governed by the principles of GCM 22366. A calendar year corporation is entitled to deduct $1.10 on its 1940 income tax return and the extra $.15 together with the next year's $1.25 on its 1941 income tax return.

Question: If a corporation calls its bonds in 1941 for redemption at a premium in 1942, but in 1941 irrevocably deposits funds for the redemption with the Trustee, in which year is the unamortized discount and premium on redemption deductible?

Answer: In 1942, the year the funds are paid by the Trustee.

Question: In 1941 a deficiency in an excise tax for 1938 is assessed and paid, with interest. For what year is the interest deductible for income tax purposes, on the accrual basis?

Answer: The interest is deductible in the years it accrued (from the date the tax was originally due). A different rule prevails for interest on income tax deficiencies. Such interest is deductible when the tax liability is finally determined by agreement, final order, or judgment.

Bad Debts

If the taxpayer is on the charge-off basis, every item at all doubtful should be written off. The taxpayer on the reserve basis should be sure to make sufficient provision. There are certain types of business which every few years sustain substantial losses and usually in years when such losses do no good at all taxwise. In one such type of business, the Treasury permitted a large reserve to be accumulated and deducted in the face of relatively nominal current losses. No doubt, all accountants can point to some business which moves in cycles and in which there are periodical losses.

The entire situation should be reviewed and if a prosperous business is extending to some customers relatively larger credits than heretofore, some consideration should be given to the situation.

Partial write-downs should be considered.

Question: If a taxpayer charged off some bad debts in a loss year, and thus received no benefit tax-wise, and later recovered some of the items charged off, would he have to report these recoveries as income in the current year?

Answer: Until this question has been ruled on by the Supreme Court, I suggest that this type of recovery be excluded from income. Full disclosure, however, should be made on the tax return.

Bonus and Other Special Compensation

If it is contemplated that special bonuses will be paid after the profits for the year are determined, provision should be made within the year. The payments must constitute a valid obligation before the close of the year in order to have the deductions allowed. The mere fact that the bonus is based on the earnings for the year is not sufficient; the payor is required to take some action *before* the close of the year to establish such relation of debtor and creditor as will permit of the deduction being allowed. It is not necessary that the *amount* be determined before the end of the year.

In view of the fact that a great many corporations intend to reward officials and others for their increased effort, the purpose might be defeated if an appropriate deduction cannot be claimed in the year. This applies to special compensation of all types, whether in stock, cash or other property. On the other hand, if amount appears excessive, some tax reserve might be required.

The Treasury is now "cracking down" on the question of officers' and stockholders' compensation. All such compensation should be reviewed to see (a) that it is in relation to the services rendered rather than to stockholdings, (b) that in the case of affiliated groups each corporation is charged according to the services rendered by the officers to the corporation. Trouble can be avoided if the officers' compensation is fairly apportioned according to the services rendered as between a parent holding company and an operating subsidiary.

Question: The directors of Corporation A, on December 1, 1941, vote a bonus of $3,000 to one of the officers to be paid on December 15, 1941. Instead of paying the bonus in cash, they decide to pay it with certain stock of the M Corporation which the corporation purchased in 1932 for $2,000 and which now has a market value of $3,000. (a) What is the corporation's deduction; (b) does the corporation realize any gain or loss?

Answer: (a) The corporation is allowed to deduct $3,000 as additional compensation provided that such amount when added to the regular salary of the officer does not exceed reasonable compensation for the services rendered.

(b) The corporation realizes a taxable gain of $1,000 since the stock is used to discharge an obligation. The tax aspect is the same as though the corporation sold the stock for $3,000 and used the proceeds to pay the bonus.

Question: If deferred compensation arrangements are made through a trust, is it essential that the contract provide the employee be engaged by the company creating the trust at the time the distribution is made pursuant to the trust?

Answer: It does not seem essential to have any such requirement in the trusts. The rule is definite that if the

amount placed to the credit of the employee is reasonable in the light of his ordinary compensation and if the donor company can not recover from the trust then other terms not inconsistent with these are immaterial.

Dividends and Section 102

Section 102 should be repealed during the emergency. It is too much to expect, however, that Congress will permit a business to retain some profits for the lean years to come. Section 102 and the federal capital stock tax are "two of a kind" in that a taxpayer must be a good guesser to meet the situations created.

The utmost that one can do in respect to Section 102 is to be sure that retention of the undistributed portion of the net income can be justified.

The accountant who points out the implications of Section 102 to a client which has no valid excuse for retaining profits is doing the client a service. However, it should be noted that where there is a valid reason for not paying out profits, it may be desirable to risk the penalty tax in order to meet the need for retaining the profits in the business. Corporations whose stock is closely held are of course most vulnerable under Section 102, especially where there have been loans to stockholders and where the taxpayer carries a substantial portfolio of marketable securities.

If a cash dividend is not desirable a dividend credit can be obtained by way of a consent dividend.

If there are tentative plans for acquiring new plant or equipment or making other substantial corporate commitments, definite action should be taken before the end of the year with respect to advancing negotiations, placing contracts or otherwise definitely ear-marking or segregating the earnings which are to be applied to financing such expansions or acquisitions.

Closely held corporations with mixed income should check their status to see that they do not come within the definition of a personal holding company. In some cases legitimate holding companies owning stocks of operating subsidiaries and bona fide business corporations have later found to their surprise that they are subject to tax as personal holding companies. Timely action before the close of the year may, in some cases, take such corporation outside the definition. For example, if they are slightly over the 80 per cent personal holding company income requirement, they might be able to realize long-term capital losses or reduce short-term capital gains. If rent income approaches 50 per cent of the total gross income, it may be possible to increase this percentage over 50 per cent and thus eliminate all rent income from the classification.

Changes in the New York State Unemployment Insurance Laws Since January 1, 1940

Paper presented by Robert T. Allen, *C.P.A., before a special technical meeting of the Committee on Social Security, November 6, 1941, Reuben Westerman, Chairman.*

During the past two years some thirty laws have emerged from the legislative mill at Albany which have in some way affected the New York State Unemployment Insurance Law. Fortunately for accountants and for their clients many of these amendments are relatively unimportant, as they deal solely with administration, minor changes in wording, or changes in the rules for the payment of benefits.

The rate of contribution payable by the employer was changed to 2.7% of the taxable payroll beginning January 1, 1940. For the years 1938 and 1939, the rate was 3%. However, an employer subject to the Federal Unemployment Tax Act was entitled to a refund of contributions paid for those two years in excess of 2.7% of the total remuneration paid by him.

Also effective January 1, 1940, certain instrumentalities of the United States became employers subject to the New York law. This amendment brought national banks within the scope of the law.

Section 502.3(d), which excludes from the definition of employers subject to the law "any corporation, unincorporated association, community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary or educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual," was amended to provide that this exclusion should not apply "with respect to persons temporarily and solely employed for construction, substantial remodeling, or demolition of buildings."

Amendments have been made to employments which are not included under the law to substitute the term "agricultural labor" for the former "employment as a farm laborer," and to make the definition of agricultural labor coincide with the definition under the Federal act.

"Employment as a part time worker of any person actually in regular attendance during the day time as a student in an institution of learning" is now an employment excluded under the law. Formerly, this exclusion applied only to minors

under the age of 21 years. The same amendment also clarified the law with respect to the status of caddies so that there is no longer any question about them—they are specifically exempt from the law.

Additional paragraphs have been added to Section 502.6 to exclude from remuneration, beginning January 1, 1940, amounts paid by employers under a plan or system of group insurance for annuities, retirement, medical and hospitalization, sickness or accident disability, or death. Also excluded from remuneration is the tax imposed upon employees under the Federal Insurance Contributions Act where such tax is paid by the employer without deduction from the employees, and dismissal payments which the employer is not legally required to make.

An employer is still defined by the law to include "the receiver, trustee or successor of a person, partnership, firm, association,—or corporation." Originally, the Appeal Board held that a vendee or transferee acquiring all or substantially all the assets of a vendor or transferor subject to the law was a successor in interest within the meaning of the law, and therefore subject to the law although the vendee or transferee did not employ four or more persons after the acquisition. The Appeal Board now holds that vendees or transferees are not successors in interest and that the term "successor in interest" was meant to apply only to statutory successions. (See also **In the Matter of Irene Turano. Myrna Wightman, doing business as Tally Gowns. New York Court of Appeals (6/12/41) affirmed New York Supreme Court, Appellate Division, Third Judicial Dept. (11/13/40).**)

The conditions under which an employer not otherwise subject to the law may elect to become subject thereto have been changed. Such voluntary coverage shall start as at January 1 provided application is filed not later than June 30 of that year. Any employer who elects to become subject to the law voluntarily must agree to remain subject thereto for a period of at least two years, and he will remain subject to the law thereafter unless, on or after October 1 and not later than the following March 31, he files with the commissioner a notice of his intent to terminate liability at the end of that year. The Attorney General has issued an opinion that an employer who elects voluntary coverage must include all of his employees and not just a specific group or part of his employees.

Except for employers who elect voluntary coverage, employers once subject to the law shall cease to be subject thereto as at January 1 only after a written application made between January 1 and March 31 of that year and the finding by the commissioner that four or more persons were not in employment on each of fifteen or more days in the preceding calendar year. The application formerly was required prior to January 31. It should be noted that employers who remove from New York or discontinue business must file a notice with the Division of Placement and Unemployment Insurance within twenty days after such removal or discontinuance.

Section 521, which refers to payroll records and reports, has been amended to include penalties for failure to comply with the demands of the commissioner for statements, etc., such penalties amounting to as much as $500 for any one calendar quarter. The requirements with respect to records have been set forth in some detail in Regulation UI 10-41. One change made by this regulation is the requirement that records be kept for a period of six years instead of four years as required formerly.

A new section, 523-a, has been added to the law effective April 17, 1941. Under this section, any employer who becomes subject to the law must notify the commissioner immediately of that fact. Failure to do so within six months makes the employer subject to a penalty of 100% of the contributions due at the date the commissioner receives notice, such penalty, however, being not less than $50 and not more than $500.

Section 528 has also been amended to include additional acts which shall be considered as misdemeanors and sets the penalty for misdemeanors as a fine of not more than $500 or imprisonment for not more than one year, or both.

A second paragraph added to Section 530 refers to hearings on disputed claims for benefits which involve questions as to whether a person was an employer within the meaning of and subject to the law or whether the employer fully complied with his obligations under the law. In these cases, the employer shall be deemed to be a party to the hearing and he shall be heard by the referee, who may decide with respect to such questions, the decision being conclusive and binding upon the employer, subject to his right of appeal.

Effective January 1, 1942, the present section 516-a will become void and the present section 523.3 with respect to refunds and credits, will be replaced by a new section 516-a. Whereas now a refund may be claimed within three years from the date of payment, the new section provides that a refund must be claimed before the later of one year from the date of payment or three years from the last day of

the first month following the end of the calendar quarter during which the remuneration was paid which formed the basis of the contribution.

The times are reflected in the amendments and rulings which refer to persons in the military service of our country. Under date of August 24, 1940, the Division of Placement and Unemployment Insurance issued an official interpretation to the effect that persons who enlist, are called into service as part of the National Guard, or are conscripted, are not available for employment during the period of such service and therefore are ineligible for unemployment benefits for that period. An interpretation issued October 10, 1940 provides that payments made voluntarily by an employer for periods during which a person performs military service do not constitute wages on which contributions are payable.

Section 502.8, which defines the base year, has been amended to include a paragraph to the effect that whenever an employee performs military service in the land or naval forces of the United States for at least ninety consecutive days during the base year and is honorably discharged from such service, the wages paid in the corresponding quarter of the preceding calendar year shall be substituted for each calendar quarter during the base year in which such military service was performed for the purpose of determining the wages paid during the base year.

The Federal Unemployment Act

Paper presented by Adolph Schoen, *C.P.A., before a special technical meeting of the Committee on Social Security, November 6, 1941, Reuben Westerman, chairman.*

Second Revenue Act of 1940 and Revenue Act of 1941

Section 701 of the Second Revenue Act of 1940, and the like numbered section of the Revenue Act of 1941 represent the only legislative enactments during 1940 and 1941 affecting the administration of the Federal Unemployment Tax Act.

Both granted relief to subject employers who had failed to secure credit against the federal tax because of delinquent state unemployment insurance contributions.

Only the provisions of the later section are reviewed here, in view of the fact that it now supersedes the earlier section and is similar to it in many respects.

Delinquent state contributions for the years 1936 to 1940 inclusive, furnish a basis for a claim for credit equal to 90% of the amount originally allowable, provided such contributions are made not later than November 18, 1941.

Credit originally allowable is fully restored, with respect to state contributions for the years 1936 to 1938 inclusive, which were made prior to December 7, 1940.

Contributions for the years 1936 to 1938 inclusive are not limited by the November 18th date if they are based upon wages paid after September 19, 1939.

There is no limiting date for the payment of delinquent state contributions for the years 1936 to 1940 inclusive, if the taxpayer's assets were in the control of a court of competent jurisdiction at any time during certain statutory periods and with respect to definite tax years.

Claim for refund, credit or abatement should be made on Form 843, using a separate blank for each taxable year. Penalties and interest assessed with respect to excess taxes, may be recovered. Section 701 of the Revenue Act of 1941 should be designated as authority for claims made after September 20, 1941. The last day for filing is March 20, 1942.

Subject employers should hasten to secure its benefits as this measure may be the last of its kind.

Some Recent Decisions and Rulings under the Federal Unemployment Tax Act

The Federal Unemployment Tax Act has created some interesting and perplexing problems.

Is an uncompensated corporate officer an employee within the meaning of the provisions of this Act?

The clerk of a corporation whose services consisted solely of recording the minutes of meetings and who made no charge for his services, which were incidental to his duties as the corporation's attorney, was held to be an employee in a decision rendered December 11, 1940 by the U. S. District Court, District of Massachusetts, in Civil Actions No. 40 and No. 558. The court quoted from the Social Security Act of 1935 in which the term "employee" was defined to include an officer of a corporation, and the term employment as "services" of any nature performed by an employee for his "employer."

In this case the court held that it was the intention of Congress to include the clerk of a corporation for the purpose of determining whether the corporation was subject to the Act.

On April 30, 1941, in No. 220 Civil, the U. S. District Court, District of Colorado, held that a nominal or honorary officer receiving no compensation may not be counted as an employee in determining whether a corporation has sufficient employees to be subject to the Federal Unemployment Tax Act.

In this case, the corporate employer had seven compensated employees during the years 1937, 1938 and 1939. The uncom-

pensated official acted as secretary of the company, kept record of minutes and countersigned stock certificates,—but rendered no services pertaining to the active conduct of the company's business. The important question here was,—"Did an employment relation exist between the officer and the company?" The court ruled that Congress had not intended to include arbitrarily any and all officers of a corporation in defining the word "employee," and certainly had not intended to include in its definition, a nominal officer receiving no compensation and performing no services, who could not be told what to do, or how to do it.

For the purposes of this act may the assistants of employee "X" be considered employees of "X"'s employer, where such assistants know only "X" as their employer, and are engaged, supervised, compensated and discharged by him?

A salesman's assistants are counted as employees of the salesman's employer in determining whether the employer is subject to the Federal Unemployment Tax Act, if the employer had actual or constructive knowledge of such employment. This was held in a decision rendered on July 30, 1941, in No. 8317 in Bankruptcy by the U. S. District Court, Northern District, California, Northern Division. In the subject case, the assistants were paid by the salesmen out of their commissions, for performing such duties for these salesmen as operating a motion picture machine, driving an automobile and soliciting for demonstrations. The employer testified that he had employed eight or more persons during only seven weeks of the year 1937 and therefore was exempt from the tax. The government contended that this number had been employed during more than twenty weeks of that year. In proving its contention, the aforementioned salesmen's assistants were counted as employees. Entries in the employer's check book for payments to these assistants which were charged to the salesmen as advances, constituted evidence of knowledge by the employer of such employment.

Many problems have arisen in connection with the interpretation of what constitutes "agricultural labor," which is specifically exempt under Section 907c of the Social Security Act.

On July 15, 1941, in No. Civil 87, the U. S. District Court, Southern District, Florida, Orlando Division, drew a fine line between services performed by employees in picking, hauling, processing, packing and sale of citrus fruit on or from groves owned or leased by the employer as distinguished from similar services of the same employees with regard to groves owned by others which the employer serviced. It was held that with respect to groves owned or leased by the employer these services were exempt, but where rendered in connection with groves owned by others and serviced they were not exempt.

The court appears to have construed the services rendered in the latter instance as having been rendered in connection with a *commercial* rather than an agricultural enterprise. Cultivating and raising the citrus fruit were held to be services fully exempt in every instance.

The importance of adequate records is emphasized in this decision. Here records should have been maintained to indicate not only wages paid for the various types of services performed, but also allocated to applicable groves so that agricultural and non-agricultural labor would be separately determinable. These records did not exist in the case described and the plaintiff employer was not allowed full recovery.

In another case, milk truck drivers, bottlers, carpenters, showmen, and clerical workers employed on a farm by an individual engaged in raising pedigreed livestock,—were all held to be engaged in "agricultural labor" within the meaning of the exemption contained in the Social Security Act. The court ruled that the duties of these employees were all in connection with and incident to the management of the farm. The case cited is U. S. District Court, Western District, Oklahoma, No. 523 Civil, July 7, 1941.

A decision of the U. S. District Court, Northern District of Illinois, Eastern Division, Case No. 47273, on January 3, 1941 concerns the interesting problem of liability of a continuing corporation under the Federal Unemployment Tax Act. In this case the corporate plaintiff which was suing to recover taxes assessed under the Act, had taken over the properties of another corporation in process of reorganization under Section 77B of the Bankruptcy Act. The securities of the plaintiff had been issued in payment therefor.

The court held that the plaintiff corporation was a distinct entity and not a continuation of any predecessor, and that inasmuch as the plaintiff did not employ eight or more persons for twenty weeks during the year 1936, it was entitled to recovery.

In rendering its decision the court stressed the fact that the original owners of all of the stock of the old firm, owned only 14% of the plaintiff company's stock, and that the principal owners of the plaintiff firm were those who occupied the relation of creditors to the old corporation.

The status of home workers has for some time been the subject of numerous rulings and a few court decisions.

Frequently, such workers were held to be employees rather than independent contractors.

An unusual, and possibly important decision, was rendered June 28, 1941 by the U. S.

District Court for the Western District of Kentucky in No. 89, which held certain home workers to be independent contractors.

The workers were principally wives and daughters of farmers who were engaged by the plaintiff under written contract, to make in their spare time, with their own equipment, within fixed time limits, specified work upon material furnished by plaintiff.

The court supported its decision by noting that the plaintiff lacked all right of control over the activities of those who might do the work, or their working hours, or their working conditions; that the plaintiff could not discharge any worker while the particular contract the latter was engaged upon, was uncompleted; and that the plaintiff had reserved the right to reject any finished product not satisfactory to him.

The court held that these elements had satisfied the test of an independent contractor relationship.

ELECTIONS

THE following is a list of applicants admitted to membership and associate membership in the Society, and also associate members advanced to membership at the meetings of the Board of Directors held on November 13, 1941 and December 4, 1941, respectively:

November 13, 1941
Membership

Morris H. Gotthilf, 19 W. 44th Street,
Of Morris H. Gotthilf & Co.

December 4, 1941
Membership

Bernbach, Harry Aaron, 110 E. 42nd Street.
Bernhardt, Arthur H., 205 W. 34th Street.
Brandt, Emanuel Robert, 17 E. 58th Street.
Causin, Joseph, 507 Fifth Avenue.
Lerner, Samuel, 110 E. 42nd Street.
Levine, Julius A., 33 W. 42nd Street,
Of Gordon & Levine.
May, John A., 1416 Temple Bldg., Rochester,
With Williams and Thomy.
Nusbaum, Ben A., 12 E. 41st Street.
Pierce, William Neil, 30 Broad Street,
With R. G. Rankin & Co.
Potter, John, Rawson St. and Nelson Ave.,
Long Island City,
With Ford Instrument Company, Inc.

Associate Membership

Drake, Gregory, 17 E. 42nd Street.
Frey, Bernard, 1440 Broadway,
With Morris Abrams & Company.
Hyman, Leo, 125 Park Avenue,
With S. D. Leidesdorf & Co.
Kass, Beulah Segal, 70 Pine Street,
With Horowitz & Horowitz.
Kaylin, Stanley M., 60 E. 42nd Street,
With Klein, Hinds & Finke.
Koyen, Howard A., P. O. Box 527,
New Brunswick, N. J.,
With Terminal Transfer, Inc.
Lambrides, Nicholas George, 475 Fifth Ave.,
Of Lambrides and Profeta.
Lashenick, Julius H., 521 Fifth Avenue,
With Joseph S. Herbert & Company.
Morrison, Nelson, 19 Rector Street,
With Emanuel M. Edelson & Co.
Puchalsky, Irving, 285 Madison Avenue,
With N. Horn & Company.
Randall, Alfred L., 535 Fifth Avenue,
With William Lipsitz.
Roth, Lawrence M., 511 Fifth Avenue,
With Samuel Shufro & Co.
Rubinson, Samuel, 16 Court Street, Brooklyn,
With Jacob J. Fass.
Seewald, Saul, 60 E. 42nd Street.
Seitelman, Leo Henry, 1440 Broadway,
With Siegel and Goldburt.
Wood, AlfredAnson, 56 Pine Street,
With Price, Waterhouse & Co.

Advancement from Associate Membership to Membership

Blum, Leon, 886 Beck Street, Bronx.
Furst, Ira, 1270 Sixth Avenue,
With Julius Lefkowitz.
Kolkmeyer, William J., 67 Broad Street,
With Haskins & Sells.
Nashner, Kallman, 56 Pine Street,
With Price, Waterhouse & Co.
Peterson, Henry P., 56 Pine Street,
With Price, Waterhouse & Co.
Stella, Joseph A., 11 Broadway,
With Wright, Long & Co.

The number of members in the Society as of January 1, 1942 is as follows:

Members	3,501
Associate Members	443
Total	3,944

Authors of Articles In This Issue

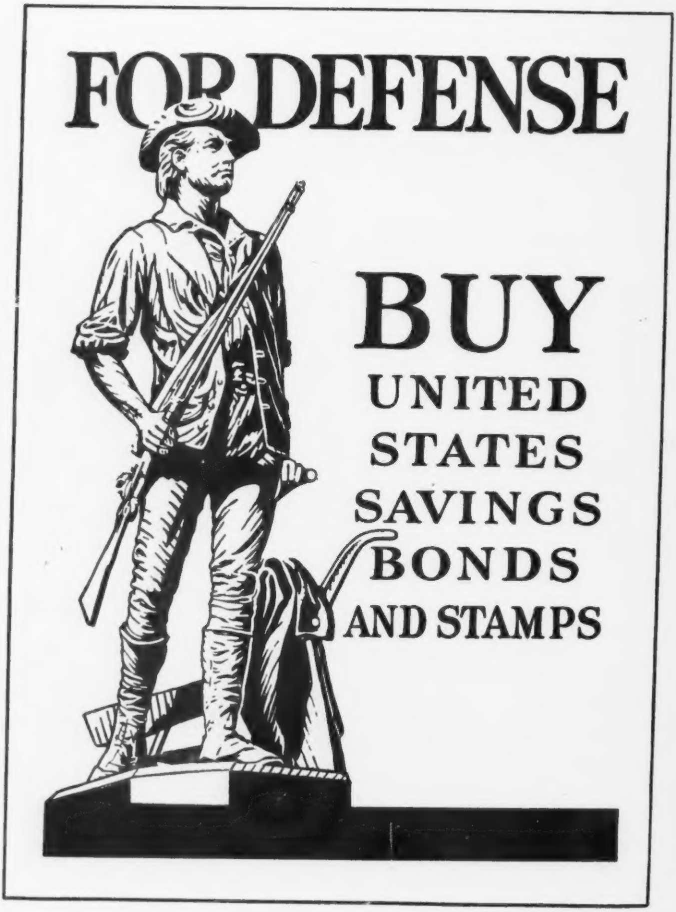
H. C. M. Cobb, C.P.A., author of **"Consolidation of Foreign Subsidiaries,"** is associated with Touche, Niven & Co. He was schooled in England and received his accounting education at the University of London. Mr. Cobb has been a member of the Society since 1939 and the National Association of Cost Accountants since 1938.

Peter J. George, C.P.A., LL.B., author of **"Interest as a Claim in Corporate Reorganization,"** is Comptroller of the Peter Doelger Brewing Corporation of Harrison, New Jersey, and received his accounting education in the School of Commerce, New York University, graduating in 1932 with the degree of B.C.S. He was later graduated from New York University Graduate School of Business with an M.B.A. degree, and from New York University Law School with the degree of LL.B. Mr. George has been a member of the Society since 1938 and of the New York County Lawyers Association since 1940. He is at present serving on the Society's Committee on Consolidations and Reorganizations.

Samuel Krieger, author of **"Procedure in Audits of Insolvent Business Organizations,"** is associated with the accounting firm of Alson & Brown. He was graduated in 1933 with a B.A. degree from the School of Education, University of Pennsylvania, and in 1935 with an M.A. degree from the Graduate School of Arts and Sciences of the University of Pennsylvania. In 1941 he received the degree of M.B.A. from the school of Business Administration of New York University. Mr. Krieger passed the C.P.A. examination in October, 1940, and is now securing the required experience for his C.P.A. degree. He has been associate member of the Society since April, 1941.

Leonard Price, C.P.A., LL.B., author of **"Recent Developments in Local Taxation,"** is a partner of Klein, Hinds & Finke, and was graduated from Columbia College in 1928 with a B.A. degree and from St. John's University School of Law in 1934 with the degree of Bachelor of Laws. Mr. Price has been a member of the American Institute of Accountants since 1938 and of the Society since 1934. He is a member of the Society's Committees on Municipal and Local Taxation, Accounting Machinery, Auditors' Liability, and Admission.

Thomas F. Thompson, C.P.A., author of **"Consolidation Rules of the Securities and Exchange Commission,"** is with the Treasurer's Office of the Metropolitan Life Insurance Company in New York City. He was graduated from New York University in 1936 with the degree of B.C.S., and in 1930 with an M.C.S. Mr. Thompson has been a member of the Society since 1936.



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